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THE CANADIAN PAYMENT SYSTEM AND THE COMPUTER: ISSUES FOR LAW REFORM

A study paper prepared by
Howard R. Eddy
1974

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TABLE OF CONTENTS

	Page
Foreword	1
Introduction	3
The Present Payment System and the Role of Law Reform	5
Social Demands on the Payment System	9
The Existing Payment System	15
Requirements for an Equitable Payment System	31
Issues Arising from the Future System	35
Summary	63
Footnotes	71

FOREWORD

In keeping with its duty to make a continuing and systematic review of the laws of Canada with a view to their modernization and reform, the Commission undertook in the fall of 1972 a preliminary examination of the Canadian payments system. This appeared to be a potentially productive area for law reform for a variety of reasons. In the first place, there can scarcely be any question of the importance of commercial law from the standpoint of the federal government. Federal laws play a fundamental structuring role in the Canadian payments system. Moreover, the major statute governing payment techniques, the Bills of Exchange Act, had not been subjected to any searching review since its inception shortly after Confederation, even though business payment practices had in the interim undergone continuing and fundamental changes. To exemplify this, one need only mention the current widespread use of cheques by consumers (a form of bills of exchange) in lieu of cash in making payment, a development undreamed of before World War II. But a more radical restructuring is currently underway flowing from the effect of computer technology in a credit oriented age.

Traditionally, members of the public generally have not been overly concerned with the shape and form of the payments system, and as a result these were designed in no small measure by the commercial community to meet the needs of commerce, as it saw it. This seemed normal enough. The subject is complex and difficult, and was considered a matter largely for the commercial community, and particularly the banks. Not only did this seem normal; it was probably quite suitable in an earlier age when the vast majority of transactions by the average person were cash transactions and the use of payment techniques such as bills of exchange was largely confined to the business community.

But the use of modes of payment other than cash, such as cheques and credit cards, is now virtually universal, and consequently the interests of the average consumer must be given far greater attention. To do this adequately will require the development of techniques for promoting a wider understanding of payment techniques and their effect, so that social demands in this area can find an adequate mode of expression. It will also require a more active role by government than heretofore in the shaping of future payments systems.

A few practical illustrations may assist in grasping the nature of the issues. When a person buys goods from a merchant, the law of sales gives him a number of legal remedies if the goods are not of merchantable quality. If he pays cash, however, these remedies are largely illusory; it is generally not worth suing to vindicate his rights. On the other hand, if he buys on credit or pays by cheque, he is in a better position. He may refuse payment or stop payment of the cheque. To what extent, one may ask, should a person's rights depend on the mode of payment? This question is all the more cogent if a person has no real choice regarding the form of payment. In developing future computerized payments systems, questions of this kind—the practical and legal effect on the consumer of using a computerized payment technique—must be considered. It is not enough to take account of the interests of those managing the payments system alone.

Again, the banks have a wide measure of freedom in dictating the terms upon which they will accept accounts from customers. We are not in any way suggesting that this power has been abused. The simple fact is that consumers are not sufficiently aware of the problems raised by this situation to ensure the development of adequate means of voicing their preferences. The situation may not have been of great consequence, in a consumer economy where cash payments was the norm, but in an age where payments through banks, trust companies and similar

institutions has become a fact of everyday life, it cannot be accepted without question. It is essential that such problems be taken into account in developing computerized payments systems.

On another plane, future payments systems must ensure that banks are not given an undue competitive advantage over trust companies, credit unions and other financial institutions through excessive control by the banks over exchanges of payments between financial institutions. Under existing law the banks exercise legal control over the most important of these exchanges—the clearings, that is, the settlement of accounts among the banks, and between banks and other financial institutions, by the exchange of cheques and similar instruments. There is no evidence that the banks have exercised this control to profit directly from the clearings, but the opportunity thus given to banks to make indirect use of this control to advance their competitive position as against other financial institutions should be of serious concern to government. Creation of an electronic clearing could accentuate the problem. Its control by the banks could inhibit innovations in the area by other financial institutions. Thus the computerization of the payments system raises a most important issue of competition policy that merits attention not only by the institutions themselves but by government.

These are but a few of the issues raised in this paper. The paper was prepared by Professor Howard Eddy of the Faculty of Law of the University of British Columbia. The Commission does not necessarily share the views of Professor Eddy on many of the issues raised, but are impressed with their importance and the need for their continued consideration. The purpose of the paper was not to find solutions. The variety of ways in which the future payments system may develop makes this impossible. Rather it was intended to explore the issues that should be considered in reforming the law and to develop a framework for future inquiry in the field. An interdepartmental committee has been established to consider problems in this area. The Commission will cooperate with the committee in delving further into issues of the kind raised in this paper.

The Commission is grateful to the Bank of Canada, and the Departments of Finance and Consumer and Corporate Affairs for the vital assistance given by members of their staff in various aspects of the study. The Commission also wishes to acknowledge the assistance given by the Canàdian Bankers Association, La Fédération de Québec des Caisses Populaires Desjardins, and L'Union Régionale de Montréal des Caisses Populaires Desjardins.

INTRODUCTION

In the early fall of 1972, the Commission undertook an examination of federal commercial law to find those areas in which a major reform effort might be most productive. This survey led to the conclusion that an in-depth preliminary study of the effect of computerization on the payment system would be desirable.

In any area in which science and business are moving as quickly as this one, developments have a tendency to outrun study. For this reason, recommendations for further work have been focused on the broad legal policies involved in the creation of a payment system to meet Canada's future needs.

Another barrier to narrowly drawn recommendations is the extreme difficulty encountered in obtaining timely and accurate data in the area concerned. Much publicly available data is out-of-date; much governmental data is held on a confidential basis as a result of voluntary disclosures or statute.

The greater part of this atmosphere of confidentiality is unnecessary. Some of the same matters regarded as private here are in other countries spread on the face of the public record. Nevertheless, the attitude of reticence is produced by long standing tradition and it will not easily change. Because of the almost unbelievable speed with which the techniques of banking are changing, it is essential that the deposit institutions begin to disclose to the consumer the sorts of development that are likely—and make known their views on the risks they are prepared to absorb.

The first portion of the study describes the institutions that participate in the payment system and the manner in which a deposit currency, transmitted by cheques and similar instruments, has come into being. It points out in general terms how the law provides structure for the payment system and how law reform efforts should approach the system.

This section is followed by an attempt to specify some of the values that are important to the users of the payment system. Such attempts are necessarily tentative. It is hoped that the paper may promote much more specific discussion by such interest groups as consumers, retailers and small business of the kinds of service they would like the payment system to provide. All too often, it is assumed that the only thing users of the payment system want is to have their deposits credited yesterday, and their cheques never presented. More articulate user demand would be very useful in guiding the development of future payment techniques.

The third section of the paper describes how payments are made with a deposit currency, and the legal system's response to the various risks involved in using and collecting cheques. The material is necessarily complicated. The section first describes the institutions that hold deposits, and their relationship to the control of the clearings—the process by which cheques and other money transfer instruments return to the institution on which they are drawn. Negotiability and liability—the legal concepts that underlie the instruments of today's system—are sketched. The cheque itself is then described as it is processed through the system: first, in its uses and the risks associated with them; then in how the law and deposit institution contracts have allocated those risks between the system and its users. Finally, the problems of the collecting institution with unpaid instruments are discussed.

The third section completes the discussion of today's paper-based system. It is followed by a short summary of how that system could be reformed, and an explanation of why such reform would be inadvisable if it was directed only to the paper payment instruments. This summary leads to a short catalogue of expected developments in the payment system, and an introduction to the analysis used in the concluding section of the paper.

The final section of the paper analyzes twelve aspects of payment in terms of expected developments. It discusses areas where legal rules are advisable and inadvisable, where present rules are inadequate, and the direction that further study of the system should take. The effect on the consumer of finality of payment and the cutting off of defenses are examined, and it is argued that both are obsolete in a world of consumer credit, deposit currency, electronic transfers, and complex consumer goods.

A summary of recommendations concludes the paper. These recommendations concern the position from which the system should be analyzed, suggested reforms of the institutions which operate the system, substantive changes in the kinds of transfer that the system will process, and basic policy for further study of rules for a new system.

THE PRESENT PAYMENT SYSTEM AND THE ROLE OF LAW REFORM

Payment systems are social arrangements for transferring money. Historically, many kinds of commodities have served as a medium of exchange. In Canada, beaver pelts, shells, copper shields and playing cards were once used as money. Today we tend to think of money as authorized paper currency. But that is too narrow. Most Canadian money has no physical existence at all—it exists only as an entry in the books of certain financial institutions.

Authorized currency consists of notes of the Bank of Canada,[1] and coin in various denominations.[2] Legal tender is declared to be quantities of authorized currency reasonably apportioned in denomination to the debt against which they are offered.[3] But United States Federal Reserve notes and coin circulate freely as money in some areas during the tourist season, and sorting a handful of pennies will generally reveal at least one bearing the Lincoln Memorial rather than the maple leaf. With money, convenience often outweighs other considerations.

Convenience in exchange and other social demands are the ultimate determinants of the payment system. Before their force, legal rules and institutions bend or break. On the other hand, legal rules or institutional preferences may deflect weak social demands. This is especially true when such demands are generally phrased, and the effect of the rule or role of the institution is complicated or poorly understood.

Most Canadian money exists in the form of deposits in banks and other financial institutions. These deposits can be transferred. The most common transfer technique is the cheque. By using a cheque, deposits can be transferred without any need for authorized currency.

There are many possible transfer techniques. The rules governing them are a complicated branch of commercial law. There are many kinds of deposit institutions that accept transferable deposits. The laws governing each kind of deposit institution are also complicated. People who are not specialists in these areas may feel they have no concern with such complicated matters. But the successful inter-action of transfer techniques and institutions to produce an efficient and equitable payment system concerns every person in Canada who handles money, from housewife to corporate treasurer.

Most people would say this paper is about "banks". But to lawyers, "bank" has a technical legal meaning. Only certain of the institutions that accept deposits can legally describe themselves as banks.[4] Other institutions, which may engage in such banking activities as acceptance of demand or short notice deposits, honouring demand instruments drawn against such deposits ("chequing"), or the making of loans for various purposes, cannot lawfully call themselves banks.[5]

Various terms are used to describe these institutions. Near-bank has been used. So have non-bank financial institution or non-bank financial intermediary. These labels are inaccurate, since insurance companies, pension funds, and sales finance companies are also non-bank institutions engaged in financial intermediation.[6]

In this paper "deposit institution" will be used to mean any institution, bank or not, that accepts money deposits and customarily repays them on demand.[7] Any such institution is a potential participant in the payment system.[8] "Bank" means a chartered bank, organized under the federal *Bank Act*.[9] "Non-bank" is used to mean any deposit institution not organized under the *Bank Act* which conducts a chequable deposit business. Some "non-banks" operate under federal charters.[10] Most, however, are provincially chartered. They include in their numbers not only corporations conducted for profit such as trust and mortgage loan companies but

also credit unions, caisses populaires and agencies of various provincial governments.[11]

Deposit institutions provide a wide variety of services apart from payment services. With respect to the payment system, however, deposit institutions are important when they are willing to transfer their deposits, and when the deposit is available in law or in fact on a demand basis. Such a deposit is money.[12]

Central banking—the economic role of the Bank of Canada—is concerned with management of the money supply to create a proper relationship between it and other factors acting on the economy. Currency in exchange is one consequence of a properly managed money supply. But currency is promoted by law as well as economics.

Money has the legal attribute of negotiability. If you steal my piano and sell it to Jones, who buys it in good faith and pays value, I can recover the piano or its market value from Jones. A thief does not have and cannot pass title. But if you steal my $10 bill and pay Jones with it, Jones taking possession of the bill in good faith and exchanging value with you, I cannot sue Jones for either physical return of the bill or for its value—$10.

The consequence of this attribute is that a seller, a person who renders service or a creditor, if they have acted honestly, need not inquire as to the source of the money with which they are paid. They bear no risk through not inquiring unless the circumstances are such as to throw their honesty into question.

Bank notes are negotiable. The only bank-notes issued for domestic circulation in Canada are those of the Bank of Canada, which are also legal tender. For many years, these notes were in promissory note form, which placed the Bank of Canada under the curious duty to pay them on presentment and exposed it to other potential duties. The notes currently issued are simply a token which is legal tender.[13] They have no intrinsic value.

Unlike a bank-note, a deposit is an intangible. It is simply a right, evidenced on the books of the bank. It cannot be transferred by delivery. However, a wide variety of transfer techniques for deposits have been developed; others could be developed. These techniques render the deposit as fully negotiable as the bank-note, and are much more convenient.

Use of a token money such as Bank of Canada notes requires public confidence in the monetary policies of government. Use of deposits as money requires public confidence in the security and integrity of deposit institutions. Although in continental Europe the transfer technique used by consumers is generally drawn against deposits held by a government institution, in countries taking their commercial law from English sources—and particularly in North America—the predominant transfer technique is drawn against a private deposit institution.

It has come to be recognized that efficient operation of the economy requires deposit-taking intermediaries for both monetary and capital market purposes. The early financial history of both Canada and the U.S. is strewn with the wreckage of such private deposit institutions.[14] Government therefore has adopted various techniques to assure that deposit institutions are able to meet their obligations.

Government deposit institutions present a special problem. Whatever the formula used to strengthen confidence, at bottom the institution rests on the political integrity of the legislature.[15]

Private deposit institutions are assisted in maintaining their ability to meet obligations by inspection requirements, statutory reserve funds, and a complicated system of deposit insurance.

Government has fostered the growth of a payment system based upon intangibles. In so doing, it acquired responsibility for close supervision of the institutions that have practical control over the intangibles. The responsibility is recognized by all levels of govern-

ment that charter deposit institutions. While the manner of exercising supervision is complicated, simplification would require changes in federal-provincial relations. Beyond the supervisory role government has recognized an obligation to insure the small depositor.

The result of these arrangements is that a transferable deposit is as acceptable as a bank-note; the differences are important only in highly specialized circumstances.[16] Maintenance of this acceptability is of fundamental importance to the economy. Government can be expected to act accordingly in dealing with threats to the acceptability of deposits in exchange.

To promote the acceptability of deposits in exchange, it is not enough to protect institutional solvency. Government must concern itself with the negotiability of the particular transfer technique. This does not mean that all transfers must be made with negotiable instruments. It does mean that the allocation of risk in payment transactions is a matter requiring governmental supervision.

Government must therefore be concerned with the transfer techniques used to exchange deposits. Legal outlines of the common techniques were settled long before Confederation and codified in the English *Bills of Exchange Act* in 1882, from which the Canadian *Bills of Exchange Act* is largely derived. The Act has provided the functional rules from which transfer techniques for both deposits and bank-notes were fashioned.[17]

The techniques by which deposits are transferred, and therefore the *Bills of Exchange Act*, are as important a part of the payment system as the institutions themselves. Negotiable transfers on shaky institutions produce deposits useless as money; rock-solid institutions and unacceptable transfers produce deposits that are useless as money.

In recent years, the federal government has devoted much attention to the capital market and to the institutions of the payment system. By contrast, transfer techniques and their governing law have been almost ignored. This is unfortunate for within the last decade revolutionary technical changes have been made in transfer techniques.

These changes are only prologue to those likely to occur in the next decade.

Canadian deposit institutions are now well-advanced in the process of internal computerization. Computerization will have profound effects on the sorts of services a deposit institution can offer its customers and the marginal cost of such offerings to the institution.

The economic power of the major deposit institutions would allow them to invest in excess computer capacity in order to create barriers to market entry. Canadian control of such institutions must be weighed against foreign control of other entrants in the computer services field. Exceedingly difficult questions of policy are posed by the effects on competition of bank entry into the computer services market.

Questions no less difficult can be posed about the confidentiality of computer processing and data storage.[18] These questions concern deposit institutions as givers of credit and as participants in the payment system.

Apart from these questions of what the business of a deposit institution is or ought to be in the computerized society towards which we are moving, the new technology raises problems with respect to transfer techniques. Very simple technological changes in the way in which deposit institutions process information could render the existing legal structure superfluous, and require the creation of new governing law. Some of these changes are taking place today.

Even more disturbing is the problem of making an orderly transition to a new transfer technology. The payment system serves the entire nation and society. Canada is not a homogeneous country. It may be years before a nationwide electronic payment

system makes economic sense. In that transitional period, people must be able to understand and cope with a system that is part paper, part electronic. The payment system must be able to function on a mixed basis, processing both kinds of transfer.

What is the role of law reform in responding to these problems? Commercial law has two kinds of rules: some involve basic policy considerations; others are technical. On the policy level, the courts have insisted on good faith, curbed predatory use of bargaining power, and sought to prevent unfair allocations of risk. These policy goals are sometimes explicitly stated, but at other times they must be inferred from the application of more technical rules.

On the technical level, the rules of commercial law are structural. They create formalized ways of doing business. Many of the rules operate only if those involved in the particular transaction have not agreed on their own solution. Others, such as the *Bills of Exchange Act*, define the consequences of doing business in a certain way.

In most commercial transactions, there is a wide range of choices among legal means. The consequence of any particular choice is simply a different allocation of losses. The risk of non-compliance with particular requirements of commercial law can usually be estimated. Businesses often run such risks if they believe they will save enough money through the risk-creating conduct to cover the estimated loss.

Suggested legal reforms must recognize these characteristics of commercial law. A clear distinction must be maintained between policy and technical rules. Both kinds of rules are affected by technological changes. But the reason for legal reform is quite different. Policy rules are justified on the basis of fundamental fairness; they must be reformed when the roles that parties to a transaction play or can play change radically. Technical rules are usually justified by convenience in common transactions; they must be reformed when they render the transaction unnecessarily costly or inconvenient.

The rules of law that structure the payment system have never been unambiguously separated into rules of policy and rules of technique. Negotiability in our legal system is the consequence of using a paper instrument in a certain form.

The present acceptability of deposits in exchange is based on the use of negotiable instruments. Because our money is mainly composed of deposits, government must promote the acceptability of deposits in exchange. Such promotion can be either through provision of structure—setting up rules on how to make a negotiable transfer—or through explicit allocation of risk between parties without regard to the form of the transaction. In pursuing the policy of negotiability government cannot forget the fundamental importance of two other policies of commercial law: the promotion of good faith and the protection of freely bargained transactions. The advantages in allocation of risk allowed by negotiability should not be blindly granted to every business that can dictate terms to the unwary consumer.[19] Fundamental fairness may require that government forbid the use of certain techniques or combinations of techniques that produce unfair or incomprehensible allocations of risk.[20] Maintenance of the core values of good faith and fundamental fairness in risk allocation is essential to successful promotion of the acceptability of deposits in exchange.

The role of law reform is to clarify understanding of the legal rules that determine the payment system. Technical barriers to progress can be identified and removed. Fundamental policy can be clarified and retained. Situations offering the opportunity for an unfair allocation of risk can be pointed out, and suggestions made for the prevention of such unfairness. In the fast-moving technological changes of today, an efficient and equitable payment system cannot be achieved without legal reforms.

SOCIAL DEMANDS ON THE PAYMENT SYSTEM

In planning for the future, it is desirable to try to think broadly about what society wants its payment system to do. Until recently, we have assumed that many kinds of payment data were too costly to gather. A computerized payment system can collect and correlate such data at reasonable cost. There are undoubtedly both desirable and undesirable applications for this data.

Computer-based systems will offer a great potential variety of new ways to make payments. Each of these new ways requires different kinds of information to be kept by someone. Learning to keep or provide such information requires changes in our daily habits, and in how we do business. Such changes are not impossible—in less than ten years we have learned to live with pre-printed cheques. But the range of possible payment patterns demands exploration from all points of view—not just that of the deposit institution system.

The following list of desirable characteristics for the payment system, which has no pretence of being definitive, is offered in the hope that it may stimulate discussion. Undoubtedly, businesses and government will be able to formulate their demands with much greater particularity than consumers. There is probably a requirement for governmentally supported research into the demands of consumers.[21]

What characteristics do users demand of a payment technique? Easy use and accuracy are clearly important. So are security and confidentiality—particularly as the value entrusted to the technique increases. For most users, record-keeping is an important characteristic, and for many probative value in court or administrative proceedings is also very important. Many users are concerned with the cost of making a payment, although most consumers seem to believe that little or no cost is associated with making payments.[22] Finally, speed is an important characteristic.

Easy use includes many factors. Among these are time, the need for signature or supporting identification, the payee's convenience, and the payee's opinion of the negotiability of the payment transfer. These factors are in part subjective. A counterfeit $10 bill is worthless objectively but, until detected, passes as quickly and conveniently as a genuine banknote. A cheque endorsed in blank, regardless of the creditworthiness and good faith of prior parties, is often an unacceptable payment device.[23]

Easy use is not a simple characteristic for other reasons. A merchant who accepts cheques must make provision for losses from bad cheques in his price structure; a merchant who accepts a third-party credit card[24] must price to make provision for losses charged back to his account and must pay a discount that covers the credit card issuer's provision for losses not charged back.[25] A risky payment device may be made easy to use by paying a price. The price can be concealed in a general provision for loss that does not distinguish between payment risks and other risks.

Easy use is important in developing any alternative to cash. For example, a cheque is often inconvenient to use in a crowded retail store. It must be specially filled out and signed. It must often be approved by the salesclerk's supervisor. These things take time; they annoy customers; they decrease the salesclerk's efficiency. Yet losses on such cheques are high enough that merchants are considering even more annoying and time-consuming procedures.

Accuracy can be defined as correct communication of payment. With cash, the accuracy problem is the simple one of making a correct count. But with instruments or messages, the problem is much more complex. Not only the amount, but the identity of the person making payment and the person receiving it must be correctly communicated. To whom the information must be

given will depend on the particular technique used.

Procedures can be a substitute for information: thus with the cheque, the payee's deposit institution and account number need not be known to the payor—delivery of the cheque to the payee is a substitute. The payee will deposit the cheque for collection through his account, thus eliminating the need for the account number and institution. Other systems may require the payor to supply his deposit institution with an accurate location and number for the payee's account.

Accuracy problems are introduced in automating a paper-based system. Information which is not placed on the instrument before issue in machine-readable form must be encoded for machines by clerks. On the usual cheque, the amount must be thus encoded. Pre-encoded information must not be inadvertently altered, erased or made unreadable.[26]

Purely technical sources of inaccuracy are introduced by using electronic communication techniques. Various control routines are available to reduce technical error to a minimum, and to refuse to execute a transaction unless it passes these error checks. But error at the source, whether human or technical, is likely to remain a principal cause of inaccuracy.[27]

The source of the message can vary. It may be a bank or corporate computer. It may be an electronic cash register, operated by a sales clerk and working through a corporate computer. It may be a simple card and keyboard actuated terminal, operated by a salesclerk or customer. The source may or may not use pre-encoded information, such as a credit card, in forming the message.

Error at the source of the message cannot be eliminated. Risk should be allocated so that the costs of errors are borne by those who make them. But fixing the responsibility for error is not cost-free. In some cases, it is more efficient to charge errors to the operation of the system as a whole than to attempt to fix responsibility.

Accuracy is a troublesome value because its discussion requires knowledge of technological capabilities, respect for business judgment in allocation of risk among those of equal bargaining power, and steadfast assertion of the interests of the consumer and small businessman, who cannot bargain equally with the deposit institution system. All these factors affect decisions on the just allocation of risk.

Security is important. Theft of money or instruments, alteration and forgery of instruments, forgery of endorsements and abuse of authority are well known threats to security. Newer techniques of payment produce new variants of these crimes, and may require new countermeasures. The adoption of new techniques for payment requires a continuing examination of the allocation of duties between deposit institution and customer.

It must be emphasized that security is not solely a banker's problem. The fictitious payee rule[28] and the rule with respect to losses occasioned by negligence of the drawer facilitating alteration[29] are instances in which the risk of loss is placed outside the system of deposit institutions by existing law. Under the usual Canadian contract between deposit institution and customer, and by law in the United States, the customer is under a duty to examine his statement for unauthorized charges.[30] Breach of this duty can be used as a defense by the deposit institution when notice of forgeries or other unauthorized charges is not promptly given. The proper allocation of risk and duties is not an *a priori* matter, but one requiring re-examination in the face of technical change.

Security also is not simply a question of the protection of the customer's account against unauthorized entries. Sabotage of the account records, whatever their form may be, is an unpleasant possibility. Security requires account records to be kept in forms that can be protected from alteration or destruction. These demands of security as to record format must be reconciled with competing

demands of accessibility for business, audit and regulatory purposes, and with the law of evidence.

In sum, security requires protection of both payment instruments and the techniques used to transfer the instruments. As the instruments become more ephemeral, the records of their use and secure procedures acquire greater importance. Records and procedures outside deposit institutions are involved. An intelligent approach to security cannot simply focus on the duties of those institutions.

Confidentiality parallels security. However, some useful distinctions can be drawn. Security requires that payment transactions take place under the authority of those who have rightful control over accounts. It extends to records in order to aid in detection of unauthorized activity. Its importance concerning records increases in cases where the payment technique itself leaves no physical instrument to be preserved.

Confidentiality considers the record not for its intrinsic or probative value in establishing payment or deterring crime, but rather for its information value. Information in computer accessible form has a greatly increased value because of the ease with which it may be retrieved and manipulated. Confidentiality received its legal form from courts responding to such questions as whether the deposit institution may inform its customer's employer or spouse that the customer is dealing with book-makers.[31] Today, information of great value concerning not only major individual customers, but the buying habits of the individual consumer, will be available in forms easily accessible to the computer.

Some examples of breach of confidentiality in a modern setting may be useful. A wrongdoer might examine the deposits of a business to discover its customers. This information might be used either to solicit the customers for a directly competing product or to prepare prospect lists for related products or services. A more subtle abuse of confidential information is to create a computer simulation—a model—of the business. Such a model can be used to predict a competitor's responses. It can also be used by a criminal employee to evaluate the probability that embezzlements in various amounts will be detected.

A deposit institution's concern regarding confidentiality parallels security in so far as these threats come from outside the deposit institution; it complements security in so far as the threats are from internal misconduct. But if deposit institutions undertake new forms of business, to what extent may those institutions avail themselves of information obtained from payment activities for other purposes?

Present law allows a deposit institution to release confidential information with the express or implied consent of the customer.[32] It may become essential for government to regulate the circumstances in which deposit institutions may take grants of such consent in favour of themselves or related businesses. Closer definition of the traditionally accepted purposes for which a deposit institution may avail itself of payment information may also be required.

Confidentiality is not only a problem of internal conflict of interest between the deposit institution as agent of its customer and as business concern. Under modern technological conditions, the line between "inside" and "outside" threats to confidentiality and security becomes blurred. Ability to gain access to a computer from remote terminals and proposed computer inter-ties for clearing present new problems in protecting information and funds of customers.[33]

Confidentiality as a social demand has other components than the economic. The degree of protection of consumer payment data poses a clear conflict between the efficiency of credit reporting agencies and personal privacy. Similar conflicts between privacy and crime prevention, tax collection, and efficient use of personal savings can be posed. Since the individual demand for privacy varies greatly it is difficult to resolve these conflicts without unduly threatening some people. In order to create a system that does

not alienate its users, it may be necessary to accept substantial inefficiencies in satisfying demands that compete with confidentiality.

Record-keeping is a demand of only some users of payment techniques for some transactions. The chequing system has been sold to consumers as a simplified record-keeping technique—because the returned cheque can be used as evidence of payment. For a business, use of cheques alone is inadequate, since the cheques may be prepared by employees who intend to divert them to their own use through various fraudulent techniques. Apart from the problem of business fraud and the question of probative value, it is quite possible that statements resulting from new payment techniques could offer substantial record-keeping advantages to many persons and businesses. Consumers in particular might appreciate the advantages of even a rudimentary computer breakdown of their payments by budget category or tax status.

Probative value under administrative or judicial rules of evidence is an important demand placed on payment records. Two issues are of major importance. The first is that the manner in which the records are maintained satisfy technical criteria for admissibility. This issue can be met by establishing the ground rules on which computer records are to be admitted. The second issue is what records of particular sorts of transaction establish, if admitted.

For example, electronic cheque substitute techniques will show to whom deposit credit was given. Standardized operating procedures could insure that this is the payee. But in techniques partly based on negotiable instruments such as cheque truncation and non-return of cheques by the drawee,[34] the payee and the depositor are not necessarily the same. Such techniques pose special problems in record-keeping, since the statement alone cannot be taken as establishing a payment record. This is particularly true where the statement simply reports the date, amount and serial number of the cheque. Under such a system the payee is disclosed only by the drawer's records, which could easily be falsified, and the cheque. Retrieval of the cheque is required to verify the drawer's records. Retrieval is costly and time-consuming. High rates of retrieval quickly destroy savings produced by these techniques. Changes in the rules of evidence might substantially change the number of requests for retrieval.

Cost has an important effect on business use of payment techniques. Much of the pressure towards cheque substitutes is produced through attempts by deposit institutions to automate their handling of payments and cut costs. Cost, in the form of provision for loss, is also a major problem in credit card transactions and some forms of cheque-based transactions. The cost of issuing and mailing cheques is a burden to major payors; the cost of manually processing incoming cheques equally burdens major payees. Only the consumer seems unaware of the cost of cheques as a means of payment in terms of the services charges of deposit institutions, postage and time. There is less social demand for a low cost payment system than there might be if consumers appreciated actual costs under the present system, or the possible savings on service charges, postage and time available with new techniques of payment.

Speed in collection may or may not be a major demand. Speeding up the existing system would reduce bank float,[35] a result considered desirable by the financial community. But the effect on other institutions and practices of the existence of a greatly accelerated payment system probably requires attention.

What are the implications for the money supply, for working capital needs, or for accounts receivable or payable as balance sheet items? If the velocity of money depends on physical constraints imposed by the present system, we can expect removal of those constraints to increase the velocity of money. Such an increase would reduce the fund of money required to service a given level of economic activity for society or an individual firm.

It may be that changes in the speed of transactions would not be uniformly distributed among various sectors of the economy. Consumers, for example, are notoriously insensitive to the effects of float and interest on their personal accounts. They might therefore be insensitive to changes in their daily balances, perhaps because they receive no interest on them. But a business receiving accelerated payment could place the money received to an interest-bearing use. Some businesses might exploit market power to profit from the opportunity to gain deposits at both ends—to insist on accelerated payment in, but pay out so that the payee received payment on the same date as before.

Economists must evaluate the probability of such changes and assess their consequences. But those interested in consumer protection, competition among financial institutions, and the business and powers of deposit institutions should also be concerned. Speed may have subtle effects on the payment system.

Analysis of the performance of the payment system or public concern about how the system works is not widespread. This is unfortunate. Discussion of the side-benefits that people would like from a payment system and of the uses of payment information that they consider unacceptable is essential. Those who are creating new techniques fully recognize that customer acceptance will be a major problem. Government will also be acutely interested in citizen response to new techniques. There is a responsibility on the part of the financial community to commence the difficult and lengthy job of public education and disclosure about techniques which they foresee as likely options in an electronic future. Only through public discussion can a tentative list of social demands be turned into concrete understanding of what the users of new techniques want.

Most proposals for new transfer techniques appear to be efforts to adapt paper forms to an electronic environment. A true exploitation of the possibilities offered by the computer will require awakening society to the potential of a system which could process payments and verify authority on an instantaneous basis. In order to understand what we want from the system, it is essential that we begin to ask how such systems would affect our daily lives.

THE EXISTING PAYMENT SYSTEM

The existing payment system is based on transferring money in bank deposits. The primary technique is the cheque. The system has been partially automated for over ten years. The existing system represents a social choice from options offered by deposit institutions.

The system has not been subjected to searching external analysis or critique in light of the possibilities offered by computer technology. Its functional rules are derived from an obsolete statute, the *Bills of Exchange Act*, and from contracts between deposit institutions and customers. In the case of the average consumer, these contracts are pure contracts of adhesion. The contract is offered on a "take it or leave it" basis to the consumer. His only choice is whether or not to adhere to the terms offered. Judicial analysis of such contracts has not been consistent with respect to their enforceability, or the criteria to which they are subject.[36]

It is true that considerable attention has in recent years been devoted to structural legislation for various participants in the payment system.[37] This kind of legislation can be seen as having two basic goals: promotion of efficiency in capital markets and assurance of minimal standards to protect institutional solvency. Attention to these goals does not ensure that payment transfers have a well-reasoned functional basis.

Discussion of payment techniques begins with the deposit element. The primary group of deposit institutions is the chartered banks. Bank deposits are readily convertible into authorized currency. The only additional risk in holding bank deposits instead of currency is bank insolvency. Against that minor risk can be balanced security against theft. Bank deposits are thus a completely acceptable store of value.

In Canada, many sorts of institutions other than chartered banks accept deposits. Various legal agreements govern the notice required for withdrawal of such deposits.[38] Some are described as trust deposits. However, analysis indicates that legally the deposit is the promise of a company operating under defined capital requirements and financial inspection to return an equivalent sum.[39] If the sum is available from the company on demand—or if the company as a matter of business practice invariably waives a notice requirement—holding such promises can be safer and more profitable than holding currency, except for the risk of the company's insolvency. In response to that risk, an involved system of governmental deposit insurance exists in Canada.[40] The existence of this system promotes public confidence, and also helps to achieve sound management. Many people hold deposits in non-bank institutions.

Principal participants in the payment system are the Bank of Canada, the chartered banks and the non-banks. Of these, only the latter two groups accept deposits from the public generally.

The present role of the Bank of Canada in the operation of the payment system is a very narrow one. As central bank, the Bank of Canada holds the reserve accounts of the chartered banks and serves as lender of last resort. These two functions allow convenient and secure payment on a same day basis of the net clearing balances in the regional clearings of the chartered banks by transfer of account credit at the Bank of Canada.[41] The Bank of Canada plays no operational role in the clearing of non-governmental items.

The Bank of Canada also issues and replaces paper money.[42] But the great majority of payment transfers are made through the clearing system. The Bank of Canada's role as bank for final settlement provides a simple and efficient means of ultimate payment between banks of transactions made through the clearing system.

The chartered banks are the core of the Canadian payment system. Although often referred to and seen by others as a group, there are significant differences in their sizes and interests. The chartered banks, through the Canadian Bankers Association, have created the existing clearing system. They maintain the commercial, institutional and personal accounts against which the great majority of payments are made. They also maintain the accounts of the non-banks through which non-bank orders are cleared, and against which settlement by non-banks takes place. They provide both reserve-holding and clearing functions for the non-banks.[43]

Canadian banking is a highly concentrated industry. Of the ten chartered banks, three account for 65% of the assets of the industry. Five banks account for 91% of the assets.[44] These five operate nation-wide. The other five can be grouped as follows. Two, although operating in other provinces, conduct the greater part of their business in Québec; the remaining three are special cases.

The two banks operating chiefly in Québec are heavily concentrated there. Over 95% of the branches are located there in one case; over 85% in the other. The remaining branches in both cases are found in areas with large francophone populations. In Québec, the branches of either of these banks outnumber those of the three largest banks. The largest caisse populaire group holds a substantial interest in the smaller of these two banks.

Of the special cases, one operates under substantial restrictions because it is foreign owned.[45] The other two, both very recent entrants to the banking community, represent less than 0.5% of industry assets.[46] It is therefore not surprising that concern for the competitive environment in banking should be a persistent note in official studies.[47]

The non-banks are a diverse group of institutions. Among themselves, they vary greatly in corporate powers, business or social goals, size and regulatory jurisdiction. Trust and mortgage loan companies, the caisse populaire groups, government deposit institutions and credit unions will obviously have many differences. But from the point of view of the payment system, they pose a common problem. These institutions issue orders that are treated as though they were cheques. In some cases, these institutions also perform clearing functions for their members and the chartered banks. They form a significant part of the payment system.

Comparisons of non-banks among themselves or with the chartered banks cannot be based on size alone. The non-banks differ, even among themselves, in investment powers, social goals, rate of turnover of deposits, and commercial sophistication of their customers. Non-banks occupy a recognized and significant portion of the market for financial services. In many areas of the country, they compete more vigorously with the chartered banks than the latter compete among themselves.

It is difficult to gauge the competitive impact of non-banks on the chartered banks. Obviously, it varies fròm province to province. But even when the presence of non-banks is taken into account, Canadian banking shows a very high degree of concentration.[48]

Concentration does promote efficient cooperation on matters of mutual concern. The clearing system—which provides the mechanism by which deposits are transferred—is one example. Through the clearing system, instruments deposited for credit are returned to the institution on which they were drawn. Banks and non-banks are to varying degrees competitive in offering deposit and loan services—particularly in the consumer market. However, non-banks and smaller chartered banks rely on nationally operating chartered banks for clearing services.

This customer-competitor relationship with the major chartered banks produces difficult problems for competition policy—problems that are complicated by the decision to permit diverse sorts of institutions to offer

services essentially indistinguishable from those offered by banks.

Access to clearing services is essential to participate in the payment system. A transfer technique is useful as a *money* transfer if it can be transformed by the payee into immediate payment in authorized currency or deposit credit.[49] A proposed deposit transfer technique must be passable through the clearings or be accompanied by a clearable instrument.[50] While it is possible to duplicate the banks' clearing network, not even the federal government has done so.[51]

Any practical competing system must reach commercial accounts. Those accounts are generally held by chartered banks. The advantages of servicing commercial payments on an account basis, as opposed to actually paying over cash, are so great that only a deposit institution will conduct this business. For reasons associated with their history, capital structure, and charters, banks enjoy considerable advantages in obtaining and servicing these accounts.

Given the concentration of the banking industry and the barrier to entry posed by bank dominance of commercial account business, the clearing system in Canada is well entrenched. Since no competitive system exists, control over the content of the clearings is control over the content of the payment system.

The kinds of items admitted to the clearings must be controlled. The present system functions on provisional credit and negative notification. A paying banker does not send word that ninety-nine items are all right; he advises that he cannot pay the hundredth. Such a system must have very low failure rates or it will not function. The clearing system has been designed to achieve such low failure rates. But on this important point there is no real conflict of interest between deposit institutions, and therefore no justification for restricting control of the clearings to the chartered banks.

The clearing system in Canada is undergoing rapid change on several levels. Its content is subject to erosion, since the vouchers resulting from bank credit card payment are not part of the clearing system. These transfers are handled separately by the various bank card groups.

If debit cards make a significant inroad on the use of cheques, and if they are marketed as an optional feature of the bank credit card, they may cause further erosion of the relative importance of the existing clearing system—particularly for consumer payments.

Recommendations concerning the control of the clearings, and equitable access to them, are equally applicable to any successor or supplementary exchange which might come into being as a result of computer technology and its applications in the payment system.

The geographic features of the system are also in a rapid state of change. Relatively recent descriptions are said to be out-dated; while an accurate description is not publicly available.[52] The points at which and the manner in which transfers are exchanged are rapidly responding to the installation of nation-wide computer communications capabilities by the major banks.

Some factors remain constant. Ultimate settlement for the banks is still made by transfer of deposits with the Bank of Canada. Settlements by non-banks for their instruments are made through accounts held by their servicing bank. The clearing rules are prepared by the Canadian Bankers Association subject to Treasury Board approval.[53] This procedure for public supervision is authorized by the Act incorporating the Canadian Bankers Association.[54]

The necessity of obtaining clearing accommodation from nationally operating banks is common to the non-banks and the smaller chartered banks. Settlement through an account with a chartered bank is a distinguishing feature of non-banks. These arrangements have economic features, affecting float and the cost of maintaining reserves.[55]

The arrangements also have features that are purely institutional. The clearing system handles the transfers of all deposit institutions. Representation on its rule-making body is restricted to chartered banks.[56] Agreements between groups of banks control the handling of important non-clearings items, such as bank credit card vouchers.

It is essential that the policy of non-discriminatory access to exchanges of payment transfers extend not only to the clearings, but also to newly evolving payment exchanges. Non-banks in the United States have recently won rights to membership in bank credit card groups.[57] Canadian developments, which are not influenced by the same legal remedies for non-banks against discrimination, must be closely monitored to ensure that non-banks do not suffer competitive injury through denial of participation in new developments.

Not only the right to participate on a non-discriminatory basis in new developments after their creation is important. Some Canadian non-banks are as advanced in certain areas of the new technology as the banks. A genuine policy of non-discrimination would open the planning of new initiatives in payment techniques to these non-banks.

If the *Bank Act* amendments contained in proposed legislation[58] are adopted, banks will be unable to agree legally on the kind of service to be provided a customer or as to persons or classes of persons from whom loan or other services will be withheld. However, they will be specifically authorized to conclude agreements bearing on the clearing system and other exchanges that have significant potential for anti-competitive abuse.

There are a wide variety of possible legal approaches to the problem of control over the clearings. They range from a new clearing and settlement system, as proposed by the *Porter Commission*,[59] through application of general statutory standards on competition[60] to expansion of the rule-making body for clearings to include non-bank representation. It does appear that the present system, if left alone, will require considerable *ad hoc* governmental interference on behalf of non-banks over the next decade.

Such a situation would seem to offer dangers of inefficient solutions, aggravation of federal-provincial relations over the status of the non-banks, and creation of unhealthy government-business relationships. It would be preferable to create a framework in which the sophisticated technical disputes inherent in creating a sound future system can be considered by experts from the banks and non-banks.

It would be desirable if consultations on the rules to be followed in exchanges of items could commence on institutionally neutral ground between the various forms of deposit institutions. Although there is federal jurisdiction to promulgate clearing rules and rules for all other exchanges, there are sound reasons of policy for doing so only as a last resort.

First, expert knowledge of the system would be difficult to gain or maintain within government without operational control of the clearing or exchange. Without such knowledge, efficient government action is limited to a corrective role. Second, the fine structure of the clearing rules will affect each deposit institution in a different manner. As long as government is committed to the concept of private deposit institutions, those institutions should be allowed an initial opportunity to resolve issues among themselves. If the result of such bargaining reveals an abuse of market power, government should of course exercise its corrective role. Third, the deposit institutions prize flexibility in response to changing situations. If formal rule-making procedures were necessary to alter all clearing or exchange practices, flexibility and speed would be lost. Formal procedures are necessary as a precaution, but they should not be the first step in the rule-making process.

The interests to be represented in such rule-making clearly include all financial institutions involved in the clearings. But the social importance of the decisions involved, technical though they are, requires more

public participation than a simple Treasury Board approval. Government itself has a conflict of interest between its role as sovereign and its managerial role over public payments, in which it is a customer of the system. An ideal rule-making body might therefore include publicly appointed members from outside government charged with representing the consumer interest or that of the public generally.

The question of governmental participation in the operational aspects of the clearing is a wholly independent one. The point is simply that although careful control of clearing practices is essential, the existing legal apparatus for such control provides inadequate representation of the interests involved.

Three levels at which action would be appropriate suggest themselves. At the operational level, the rule-making should take place in the private sector, though subject to governmental monitoring. All deposit institutions should be represented. A procedure whereby rules are filed to take effect unless objected to within ninety days might be appropriate. The second level—that of supervision to achieve settled policy—would be achieved by exercise of the power to object. A procedure for formal rule-making should exist to resolve situations in which the institutions were unable to propose acceptable rules. The third level of action would seek to broaden the public's understanding of policy, and to promote creative exploitation of the new technology. On that level, a policy advisory committee drawn from governmental, consumer and business users of payment services could be created. The committee could be used as a sounding board for proposals by deposit institutions and regulatory initiatives. Such a committee is likely to be useful during a transition period between two technologies such as the present.

Where in the government structure should the supervisory and policy advisory levels of the suggested structure be located? Because of the nature of the decisions involved at the supervisory level, existing expertise would be found primarily in the Department of Finance and the Bank of Canada. There is a strong argument that these decisions should be insulated from political considerations. That argument would favour placing the second level of regulation at the Bank of Canada.[61]

Locating the policy advisory committee is more difficult. Its function is likely to raise questions touching on broad aspects of policy, which may become political. A possible solution would be for the committee to be provided staff and administrative services by the Bank of Canada, but to report publicly to the Governor of the Bank and the Minister of Finance. Questions of responsibility between those officials could be adjusted amicably. If not, existing law provides a model for their resolution.[62] The public nature of the report would provide Parliament itself with the material for resolution of differences, and might also serve a useful educational function where differences did not exist.

The creation of such a structure can aid in adapting existing clearing procedures to the new technology. But these procedures are only the general functional aspects of the payment system. Its particular aspects are determined by the uses and legal characteristics of the common transfer techniques. Two concepts can aid in understanding these characteristics—negotiability and liability.

Negotiability as a policy has already been mentioned. As a legal doctrine, negotiability is concerned with payment by cheque, bill of exchange and promissory note.[63] It is involved as both doctrine and policy in attempts to create new transactions that produce risk allocations similar to those achieved by use of negotiable instruments.

Negotiability is the concept by which the transfer of a payment is protected. If all money had intrinsic value, negotiability would simply specify how property rights in money could be transferred. Since negotiable instruments have value only because of someone's liability to pay them, negotiability establishes the rules by which the benefit of that liability can be transferred. Inextricably connected with those rules are rules governing the effect of payment to a transferee of

the instrument, and the extent of the transferee's rights if there is a dispute between others who have dealt with the instrument.

Under existing law, negotiability creates five classes of transferee. Two of these classes are of continuing importance—holders and holders in due course. The others are legally or practically insignificant.[64]

The distinguishing characteristic of the holder in due course is that he takes the instrument free of claims that could disturb his rights to enforce it and without being subject to most defenses to its enforcement. Abuses of this status by consumer credit financiers led to major reforms with respect to certain common financing arrangements in 1970-71. It is common to attempt to reproduce the advantages associated with the status of holder in due course by other devices.[65] These devices raise important questions of policy, and will be discussed later in the paper.[66]

The form of the instrument establishes the method by which a transferee must take it to become a holder. The thief of an instrument in bearer form can make his transferee a holder; but the thief of an order instrument cannot. The necessity to forge the endorsement of an order instrument to negotiate it after theft produces a totally different distribution of losses than exists with the bearer instrument. Since this pattern of loss distribution lies at the base of the cheque payment system, it will be discussed more fully later.[67]

In addition to transfers in bearer and order form, the law recognizes endorsements which strip an instrument of all or part of its negotiable character. The principal effect of such forms of endorsement is on the institutions operating the clearing system.[68]

Negotiability describes a set of transfer formalities, their legal consequences, and the policy of free exchange of commercial instruments that those legal consequences promote.

Cheques and bills of exchange are defined and structured by the *Bills of Exchange Act*. These *paper-based* transfer techniques are the core of the existing payments system. Both the definitions and the functional rules applicable to negotiable instruments under the *Bills of Exchange Act* are impossible to apply at present to a transfer that is not paper-based.[69]

The various forms of negotiability are useful in describing the transfer of instruments and the distribution of losses. Liability is useful as a concept in discussing who can be sued if an instrument is not paid. Opinion about the ease of such suit, the probability of being forced to bring it, and the chance of collecting a judgment will all affect the acceptability of a transfer technique.

The signers of negotiable instruments are allowed a limited number of roles by law. Each signature to the instrument must be classified into one of these roles, and each role has its associated liability.

Makers of notes and acceptors of bills of exchange are primarily liable. Payment in due course by one who is primarily liable discharges the instrument.[70] In most circumstances, there are no formal steps that necessarily precede suit of a person who is primarily liable.[71]

Drawers of bills and cheques, and all endorsers, are secondarily liable. If they pay the instrument, those who are secondarily liable may sue prior endorsers, and the maker or acceptor if there is one. The conditions of their liability are that required presentments be made in a timely manner,[72] and that required notice of dishonour be promptly communicated. Failure to give required notice of dishonour discharges any party entitled to receive it. Failure to present or negotiate a cheque or demand bill within a reasonable time discharges endorsers; the effect on the drawer is more complicated.[73]

The drawee of a cheque or demand bill is not liable on the instrument. The signature of a drawee acknowledging liability on the instrument is usually known as acceptance, and the liabilities of an acceptor are discussed above. But cheques are not intended to be accepted. The drawee's acknowledge-

ment of liability on a cheque is a certification. Certification renders the drawee primarily liable, but it can be revoked.[74]

Acceptability is not based solely on someone being primarily liable on the instrument. Payroll cheques and other secondary liabilities of well-known businesses may enjoy a wide acceptability. Government and bank drafts enjoy an acceptability based more on the credit of the issuer than the nature of the liability.

Liability indicates whose obligation to pay the taker has, and the circumstances necessary to enforcement. Obviously, the primary liabilities of deposit institutions or major corporations are more desirable than secondary liabilities.

Cheques are peculiar in that they carry only secondary liability. The creditworthiness of the drawer and the endorsers, if any, is not usually well-known. Yet cheques are usually collected through the clearings, and deposit credit given against them, as though they were unquestionably to be paid.

A cheque is a bill of exchange, drawn on a bank and payable on demand. No one is primarily liable on a cheque. The drawer is secondarily liable.

However, the logical results of this analysis concerning duties of presentment and rights to notice of dishonour have never been consistent with the common law. Apart from the problem raised by bank failure, the governing law is by no means clear. If the drawer is not prejudiced by delay, presentment within the period of the statute of limitations is timely. But what constitutes prejudice, whether delay in the face of facts showing prejudice evidences the payee's intent to take the cheque as absolute payment, and whether discharge of the cheque necessarily discharges the underlying obligation are issues on which the law is insufficiently clear.[75]

Although cheques can be drawn payable to bearer, most are drawn in order form. About 90% of personal cheques and almost all business cheques except those for wages are never negotiated outside the deposit institution system.[76]

Order form cheques are almost perfectly adapted to making payment by mail of open accounts or instalment loans—which are very important business patterns. The payee takes no credit risk in excess of what he has already incurred. He need not worry about theft.[77] Relatively simple procedures can guard against diversion of cheques by employees of the payee.

Cheques are primarily useful in eliminating periodic visits to a creditor or his agent to make cash payment. The dominance of the cheque in personal payments is a by-product of a merchandising system that has come to rely heavily on consumer credit and centralized billing and payment.

Since these cheques move from individuals to pre-existing creditors, they are a very low risk instrument. Forgery of a cheque that can benefit only the ostensible drawer is unlikely to occur. A "stop order" is unlikely, since the drawer generally has the goods or services already. Unless his dispute is newly discovered he never would have drawn the cheque.

Trouble resulting from the negotiation of such cheques requires either theft and forgery of an endorsement or employee misconduct. Unless the creditor is doing business under his own name as a natural person, or supplies his employees with the appearance of an authority to endorse generally, such cheques would never be cashed or accepted for deposit. Credit trouble may still occur. But it is traceable to the account, not the cheque. If the cheque is returned for insufficient funds, the payee is still better off than he was before it was issued.[78]

Some businesses, particularly major food chains, create a file of credit information through a "cheque-cashing card" system. They attempt to transform the faceless continuing relationship of shopper and merchant into a more formal one. Such a system can reduce credit and forgery risks, and the merchants concerned are seldom exposed to dis-

putes in which a stop-order is likely. Use of such a system can also decrease exposure to forged and stolen payroll cheques.

Businesses that accept cheques without adequate precautions are an easy point at which to commit fraud. But such businesses do not necessarily bear the resulting loss. When a forged instrument is paid, the loss remains by law on the payor unless the forger can be located.[79] If other instruments are paid, there are costs involved in shifting the loss from the payor through the collecting institutions to the careless business. The unrecoverable portion of these costs may exceed the loss suffered. In ultimate result, the deposit institutions act as insurers—spreading the risk and passing it back to their customers.

Large numbers of cheques, with or without an associated credit account or "cheque cashing card", are taken in payment at the retail point of sale. Losses on these cheques are high. For this reason, and because relatively large numbers of cheques pass through the hands of a few major retail sellers in any city, much attention has been focused on the *point-of-sale cheque.*

A point-of-sale cheque is generally given for the price of goods sold. Apart from cases where the customer's character is known or a credit account or cheque cashing privilege exists, the merchant takes the cheque as a cash equivalent and gives cash, goods or both in return. Obviously this is a risky transaction for a merchant. Some refuse all cheques, almost none will cash a cheque for money only, a few will cash a cheque for goods plus a small amount of cash. Most will take a cheque for the price alone to make the sale. Such patterns change from province to province, and from city to town.

There are major risks on a true point-of-sale cheque. The ostensible drawer may be a forger; he may be honest, but become dissatisfied with the goods and stop payment.

The credit risks are even more alarming. The payee has no continuing relationship or independent knowledge of the drawer's credit status. Even if the cheque was good when drawn, it may not be paid because the drawer's account has been garnisheed. Occasionally it is not good when drawn. The seller has usually parted with possession of goods in reliance on a point-of-sale cheque. He suffers genuine injury from its non-payment.

Other sorts of personal transactions involving cheques must be mentioned. Cheques are often used to make gifts or for miscellaneous petty payments by mail, where the amount involved is too small to justify dispute.

For business accounts, different factors assure the dominance of cheques. Small business is very largely financed by chartered banks. The role of the chartered bank in responding to loan demand is to create deposit balances in favour of borrowers. The inter-relationship between the loan and deposit sides of the account has legal and commercial complexities. But the necessity for the bank to monitor the account to protect its loan position assures that commercial receipts will be passed through bank accounts. Most payments are made at a distance, and for book-keeping reasons the payee is identified. Security, book-keeping and the bank's justifiable reluctance to be made a party to commercial buyer-seller disputes dictate that the payment be made by an order instrument in negotiable form. The necessity to put the transaction through the bank account, coupled to commercial considerations, narrows the choice to the cheque.[80]

As has been pointed out, the typical cheque—personal or commercial—is never negotiated. It is deposited for credit by the payee. In the normal course of business the cheque is collected by the payee's deposit institution through the clearing system from the payor's bank. The bank debits the payor's (drawer's) account. If the debit is improper, the bank must recredit the account.

A debit may be improper because of successful forgery, payment of an unauthorized person, or material alteration of the cheque,

commonly by raising the amount. A bank which has paid a forged cheque cannot charge it back or shift its loss by suit.[81] Forgeries, however, are usually discovered either before payment or by the drawer's examination of his cancelled cheques and his books. With forgeries, the crucial legal issue is usually the drawer's right to force the bank to recredit his account. Banks provide in the contract establishing the account that failure by the drawer to object to unauthorized charges within a specified time after a statement is rendered is binding on the drawer; sometimes they print this on the statement as well.[82] When enforceable, these provisions shift the loss of successful forgery from the bank to the payor after lapse of the time for objection.

Payment of an unauthorized person generally occurs because of a forged endorsement. It can also occur if an instrument is paid with knowledge of an adverse claim later found to have been valid.[83] Such payment creates potential double liability. The bank is unable to charge the drawer's account unless it can discharge the instrument. It is liable in the common law provinces to suit by the true owner of the cheque for conversion if it pays someone who is not a holder.[84]

The remedies in this situation are partly under federal statute and partly under provincial law. Payments of cheques with forged endorsements are binding on the drawer unless he notifies the drawee in writing within a year of their discovery.[85] If notice is given, the drawer may proceed against his own bank under the statute. The true owner may sue the collecting bank and others who have dealt with the instrument for conversion. If notice is not given within a year after discovery the cheque is deemed paid.[86]

If the payor misjudges an adverse claim, rather than paying a forged endorsement, there is no statutory provision. The drawer can demand recredit unless barred by contract or local law; the true owner can assert a common law action in conversion, or in Québec an action under Article 1053 of the Civil Code if fault can be shown.[87] If the collecting bank has represented a person whose title to the instrument is voidable, rather than a nullity, it is not liable if it has paid over the proceeds it has collected to its principal without notice.[88]

In the common law provinces the paying bank cannot be made liable for conversion if it could successfully charge the cheque to the drawer's account absent its contractual rights.[89] While the legal theories behind these actions vary, the recovery in each will be the face value of the instrument.

Material alteration of a cheque generally consists in raising the amount. It can be honest, but it seldom is. Where the alteration is not apparent on the face of the cheque, holders in due course can enforce payment of the cheque as originally drawn. Where the alteration is facilitated by the drawer's negligence, those injured have a right of action against the drawer.[90]

Generally speaking, a material alteration is made with fraudulent intent and is not apparent on the face of the cheque. The loss caused by an artful raising of the amount of the cheque will fall initially on the paying bank. If the customer has been negligent in drawing the instrument or fails to object to the unauthorized charge, the loss can be shifted to the customer. If the paying bank cannot cover the loss in this manner, it has an action for money had and received against the collecting bank, and in theory the loss is passed back through the collection system and the depositor and prior endorsers until it reaches the person who dealt with the wrong-doer. As a practical matter, the loss will be absorbed somewhere in the deposit institution system unless the expenses of suit are justifiable.

Where the bank pays on a forged endorsement or otherwise to one who has no title to a cheque, it is exposed to a second liability. The true owner's action for conversion or fault is independent of the bank's treatment of the drawer. The drawer need not wait for settlement or suit on the owner's action. While theory suggests there should only be one loss, as a practical matter the bank may be forced to settle or conduct two actions.

Except in rare cases involving substantial sums, deposit institutions as a group absorb the losses of *paid* forgeries, forged endorsements, adverse claims and material alterations. Why? First, the account agreement has not changed consumer behaviour. Many people do not conscientiously verify their bank statements on a monthly basis. A bank that stood on its legal rights would lose consumer customers, even if those customers knew they would be getting the same deal around the corner.

Second, assuming that the agreements would stand in court against a consumer plaintiff on other grounds, the examination of signatures, endorsements and other features of the cheque is so cursory under modern conditions that a consumer could probably argue either negligence or fundamental breach with a fair chance of success in the case of forgeries or apparent raising of the amount of the cheque.

Third, even when a deposit institution is prepared to fight, it may choose to sue its way back through the collection system instead of enforcing a charge to an account.[91] If the wrong-doer is a depositor, deposit institutions as a group still stand the loss.

In result, the deposit institutions are said to insure the chequing system. The true picture is more complex. The typical consumer may be totally deceived as to his rights or the bank's policy on disputed accounts. Such deception is cultivated by the terms of the account agreement.[92] The usual policy of insurance is consciously obtained by the insured against known or anticipated perils. This "insurance" is extended by deposit institutions against perils aggravated by their own conduct. Its terms and conditions are unknown, and abide in the conscience of the individual manager and private corporate agreements of the deposit institutions. It is predicated on a negative-notification system, which, however just in relation to a commercial account, is unrealistic when applied to consumers. If bank transfer services are extended from present users to include the public generally, loss allocation based on the existing duty of verifying the account would require a fictional view of the new account holders' behaviour.

If allocation of risk in the chequing system is on an insurance basis, it should be made explicit.[93] If it is not, an alternative to negative notification will be required for the verification of deposit balances before banking accommodation for payment purposes is extended beyond its present reach. Empirical research could probably demonstrate that negative-notification verification is a fiction with respect to a substantial portion of even middle-class personal chequing customers. It may be just to allow them to take such risks if they so choose. But it is certainly unjust to allow the existing system to be imposed on those who do not understand how it affects them.[94]

Banks do not customarily advertise: "Every month we figure out how much we owe you. If you don't like our figures, you'd better complain quick; otherwise we won't accept your proof. That's tough, but otherwise we couldn't make the system work." Maybe they should. That, in essence, is their case for the existing contractual system of loss allocation on paid cheques.

Unpaid cheques, apart from rare cases of wrongful dishonour, result from insufficient funds, stop orders, or the paying bank's detection of forgery and other irregularities. A cheque that is unpaid is returned through the clearing system to the deposit institution where it was first deposited.

Under the typical account arrangement, the deposit institution undertakes to act as agent for collection of items deposited to the account. In the case of cheques, credit is extended for the items deposited long before they have been collected. The terms upon which credit is extended may vary; deposit institutions generally reserve a power to block withdrawals of uncollected funds. But it is not uncommon for an overdraft to be created if a returned cheque is charged to the depositor's account.

A collecting bank acts as its customer's agent. If in that capacity it allows its customer to overdraw, it has simply loaned money to the customer.

However, the collecting bank has a general lien on all property of the customer in its possession.[95] Because of this lien, it is treated as having given value to the extent of its advances against negotiable instruments in its possession. But since a transferee who has given value for an order instrument may compel the endorsement of his transferor for the purpose of perfecting the transferee's title,[96] a collecting bank is not only an agent, but a holder for value to the extent of its lien.[97]

A non-bank would be similarly situated to the extent to which the court found its contract with its customers embodied the right of banker's lien.[98]

In its dual capacity as agent for collection and holder for value to the extent of its advances, the collecting bank is often entitled by reason of its good faith and want of notice to claim the further rights of a holder in due course. But these rights are contingent upon the collecting bank acquiring the status of holder.

The status of holder can be acquired only by negotiation. An instrument restrictively endorsed is incapable of negotiation.[99] While its possessor may be entitled to sue in his own name, he is subject to all defenses—including want or failure of consideration—to which his transferor was subject.[100]

It was therefore not surprising that in 1962 an Alberta court held that a bank, having extended credit to its depositor against uncollected cheques which had been deposited endorsed "Deposit ONLY to the Account of X", was subject to any defense good against the depositor. As the depositor had fraudulently induced the drawer to stop the cheque and then obtained payment, the bank's suit against the drawer failed.[101]

An owner should not be able to improve his position by transferring title to a mere agent for collection, and the Alberta decision was both orthodox and conceptually sound. However, it is incompatible with banking practice.[102] Deposits of cheques are credited as made. Accordingly the return of a dishonoured cheque will often send an account into overdraft. But if the cheque has been deposited under a restrictive endorsement the bank is limited to its depositor's rights. For security reasons most commercial depositors endorse restrictively.

In Canada the orthodox legal position is that the payee cannot be a holder in due course.[103] Since the great bulk of cheques are deposited by the payee, deposit institutions were placed in a particularly exposed situation; their alternatives were to require unrestricted endorsement in all cases (unacceptable to their commercial customers) or to hold against advice of collection the funds credited on instruments restrictively endorsed (unacceptable for bookkeeping reasons to the banks).

By reason of the restrictive endorsement, the normal ability of the deposit institution to progress from holder through holder for value to holder in due course, dependent upon its actual position as to credit advanced, good faith and want of notice, was blocked.

Legislation was accordingly obtained—in an *ad hoc* and hasty fashion—which purported to restore participants in the cheque clearing system to their original status.[104] The result obtained is greatly in excess of correction of the evil perceived from the Alberta decision. The statute deserves, and will probably receive, judicial construction averse to its plain language. Unfortunately, it is so plain that it is a potent tool for disposing of lawsuits before they are ever brought.[105]

The risk faced by a collecting deposit institution is simple. It is that its depositor will disburse, or withdraw and spend or abscond with, funds advanced against instruments in the process of collection. To the extent that such funds were advanced in good faith and without notice of defenses or irregularities, it is entirely reasonable to give the collecting

institution an interest in the instrument. The legal label for the appropriate status would be holder in good faith, for value and without notice, of a security interest in the instrument to the extent of the advance. Had the legislation provided that a collecting deposit institution would have this status, regardless of the form of endorsement, if the endorsements established a genuine chain of transfer from payee to collecting institution, and if the collecting institution had advanced credit in good faith and without notice, it would have done what its sponsors claimed it was supposed to do.[106] That is, it would have protected the collecting institution as a participant in the payment system from the coincidence of insolvency or misconduct of a depositor and dishonoured instruments upon which credit had been extended. Since such risk, if borne by deposit institutions, will be shifted to the public generally as users of the payment system, it is fair that it should be borne by the drawer.[107] He at least in most circumstances has dealt with the wrong doer.

The legislation, however, went much farther than this. It provided that:

> Where a *cheque* is delivered to a *bank* for deposit to the credit of a person and the *bank* credits him with the amount of the cheque, the *bank* acquires all the rights and powers of a holder in due course of the cheque.[108]

The legislation is doubly discriminatory against non-banks. First, their instruments, which are cleared as cheques, are not protected by the statute in the hands of a collecting institution. Second, as collecting institutions, even if collecting cheques, their protection is wholly dependent on the conduct of their servicing bank. Only banks are afforded protection in their own right. If protection is necessary to a clearing institution, the effect of the statute is to lock non-banks into the existing client relationship.

Apart from the obvious point that whatever protection is necessary should be extended to instruments and institutions on a non-discriminatory basis, the statute unjustly alters the drawer's position in the following respects.

First, to the extent that the bank collects as holder in due course by statutory fiat an amount in excess of its loss on the overdraft it has unjustly benefited the payee.[109]

Second, to the extent that the bank did not in fact take in good faith and without notice, it has been given a totally unjustified advantage amounting to legalized fraud. While banks maintain a high standard of commercial conduct, no one is perfect. The normal rules with respect to holder in due course status and presumptions in suits on negotiable instruments provide all the protection needed by honest men—banks do not require an extra security blanket.

While commentators assume that any court construing the statute would imply at least a requirement of good faith if not one of reasonable business conduct, the plain language of the statute may well deter a test of this theory.[110]

Third, the legislation on its face plays havoc with the rest of the law. There is, for example, no requirement that the depository bank make out even a colourable right to possess the cheque. Does the statute eliminate the need for endorsements? If so, in what situations? Under the language of the legislation a bank can collect for its face amount from drawer or drawee a cheque drawn payable to John Smith and deposited for credit without endorsement to the account of William Roe. It may be desirable to give banks protection in supplying the depositor's endorsement on an otherwise regular instrument deposited to his account. But the legislation goes much further than that.

Neither the depository bank, intermediate banks, nor the payor institution would be liable at John Smith's suit for conversion or under Article 1053 of the Civil Code if the above cheque were paid.[111] Regardless of law, no reputable financial institution would supply an endorsement or accept a deposit in such a situation except by gross mistake. Yet the law seems to require neither endorsement nor title to collect the cheque.

There is little point in further cataloguing the defects of section 165(3). The law has given the banks uncontrolled power. For the present they are guided by custom. What will control them in dealing with innovation, where custom is an uncertain guide?

When cleared instruments are returned unpaid, what should the rights of deposit institutions be? If one accepts the premise of the institutions themselves—that they are in business to handle money, not lawsuits—then their initial legal position is a fair one. They are the agents of their customers for the purpose of collection—they undertake to carry no collection risk.[112] All loss due to non-collection should be passed back to the depositor by reversal of the accounting entries extending the provisional credit. There are two important exceptions: improper collection and insufficient funds in the depositor's account to cover the item when it is charged back.

Improper collection occurs when a depository collecting institution or its sub-agent breaches whatever duties are laid upon it by law. Unexcused failure to present within a reasonable time and failure to give required notice of dishonour within the requisite time are obvious examples.

Improper collection is an exception to the general rule regarding collection risk. Deposit institutions hold themselves out to the public as experts in the transfer of money. The law should keep them to this standard. Because the typical customer has neither the knowledge nor the power necessary to bargain with a deposit institution, the standard should be unalterable by contract.

Collection usually involves more than one deposit institution. The law must therefore settle the responsibility of the depository institution for any improper conduct by subsequent institutions. There is no justification in bank collection practices for deviation from the normal rule that an agent is liable for the omissions or misconduct of sub-agents. Once again, the lack of knowledge and disparity of bargaining power require that the liability be unalterable by contract.

While strict control of the contract between customer and deposit institution is desirable on this issue, there is no policy objection to allowing the institutions involved in the transfer of payments to shift such losses among themselves by agreement. Such agreements should be subject to public scrutiny through whatever body is created to supervise clearing practices,[113] for these agreements are closely related to the clearing process and could have significant anti-competitive potential.

Detailed specification of what constitutes proper collection practice is intimately involved with existing and future payments techniques, deposit insurance coverage and the probability of institutional insolvencies. It would be a waste of time to elaborate a set of standards for bank collections based on existing law. It is desirable to elaborate such a set of standards based on the new payment techniques as part of a general reform.

The other exception to the general allocation of collection risk arises when there is an insufficient balance in the depositor's account to permit a chargeback of an uncollectable instrument. There are several factual variants of the problem.

The easiest case is when the depositor is, or can claim the right of, a holder in due course. In such a case the deposit institution is entitled to the rights of a holder in due course by virtue of the "shelter doctrine",[114] a general rule of law designed to promote negotiability. Commonly, however, the depositor is the payee, or for other reasons cannot claim to be a holder in due course. What should the rights of the deposit institution be in this situation? Several factual variations can be distinguished. The depositor may have drawn against uncollected funds, but otherwise be solvent. The depositor may be insolvent, having drawn against the funds, but not otherwise indebted to the bank. Finally, the depositor may be insolvent, and that insolvency may include claims by the bank in addition to the overdraft produced by the chargeback.

If the depositor is solvent, the institution should be required to pursue him if it wishes to recover. Its primary claim is based on its agency status. Although the usual course is to pursue the depositor, this is not always done. It should be a required first step.[115]

When the depositor is insolvent, either the drawer or the deposit institution must bear the loss attributable to the funds advanced. If the institution made the advance in good faith, without notice and under a valid chain of endorsements,[116] its claim is superior to the drawer. Once recovery from the wrongdoer is ruled out by his insolvency, the institution's rights against the drawer must be determined. Ultimately, the institution's right is limited by the extent of its lien. If it is allowed to recover the face value, it must account for the surplus to its depositor. But since the depositor could not have succeeded in an action on the instrument, the drawer has a claim on the surplus superior to general creditors of the depositor.

Except for the problem that the institution might not adequately represent the depositor in an action to which he was not a party, the solution would appear to be to allow the institution the option of suing under the shelter doctrine and asserting the depositor's rights, or having its initial recovery limited by its lien.

In almost every case of commercial insolvency that lien will equal or exceed the amount of the instruments subject to it. This state of affairs results from the exercise of the deposit institution's rights of set-off, based on the depositor's liability to the institution for notes given to raise working capital.

It could be argued that in this case the credit has not been advanced against particular instruments, and accordingly should not be treated as part of the institution's justification for recovery. Given the basic position occupied by set-off in banking,[117] this argument must be rejected. Once deposits are credited to the current account, they become an unidentifiable portion of the whole. But because of the rights of set-off, the current balance and its trends are an important index of the exposure of the institution. So, in fact there is reliance by the institution on the deposit.

The preceding material has relied heavily on a distinction between paid instruments which cannot be returned, and unpaid instruments, upon which the initial adjustment of loss takes place by charge-back to the depositor. Payment is also important to determine the state of an account on bankruptcy and notice of garnishment or of death—all of which terminate the duty of the paying deposit institution to obey the drawer's order.[118]

Whether the termination of authority is voluntary or involuntary, and whether it is accompanied by a saving clause for transactions in good faith[119] or a power to pay in the absence of notice of adverse claims,[120] it is important to have a clear-cut test for payment. This is true now, and will be increasingly true if real-time processing of accounts is adopted.

Any rule adopted will require careful consultation with deposit institution systems and operations personnel. But a clear-cut rule might be very useful in simplifying planning of the new systems.

Yet another defect in the existing system is the extent to which clear discussion of the most common payment technique—the cheque—is complicated by an obsolete distinction between demand bills drawn on chartered or savings banks—which are *legally* cheques—and demand bills drawn against deposits in non-banks which are perceived by the general public as cheques, but which legally are not cheques.

The distinction produces anomalies in the law with respect to stop-payment orders,[121] and the effect of institutional insolvency.[122] It has been condemned by legal scholars,[123] needlessly complicates litigation[124] and produces useless statutory prolixity.[125] Moreover, the distinction is used to avoid facing important issues of law.[126]

Why is the law in such disarray? Several causes may be assigned. No significant reform occurred between 1890 and the mid-1950's. There were more pressing problems to be dealt with. In the United States, the provisions of the Uniform Commercial Code, while generally an improvement over the *Bills of Exchange Act*, display a pro-bank orientation. In addition, the transplantation of Uniform Commercial Code concepts to Canada is a difficult and time-consuming task.

Other factors are also at work. The degree of concentration of the financial community and the impracticality of enforcing legal rights in small transactions have tended to reduce litigation. As law falls further and further away from contact with actual practice, business acquires corresponding contractual freedom which it exploits.

The rules governing the present payment system are understood by almost no one but the financial community and its counsels, and that group is so small as to be able to resolve most communal disputes on an extra-judicial basis. Disputes outside the group are adjudicated with respect to a structure that is largely irrelevant, and can only rarely cause serious damage to the interests of the chartered banks. In the rare cases where such damage occurs, curative legislation is immediately obtained from Parliament.[127]

REQUIREMENTS FOR AN EQUITABLE PAYMENT SYSTEM

An equitable payment system would ground its functional rules on statute or publicly arrived at allocations of risk. It would express those rules in twentieth century language and concepts. It would show no unfair favouritism to any group of institutions. It would have a simple set of transfer techniques. The public would be educated in all the basic characteristics of those techniques—not simply those favouring the self-interest of certain groups.

Government could produce such an equitable system by rationalizing existing institutions and practices. The rationalization would create a modern structure for payment transactions, and settle basic obligations of good faith and fundamental fairness. It would require balancing policies favouring negotiability in commercial transactions and consumer protection in consumer transactions.

Such a rationalization would be directed to:

1. the terms of access to and control over the clearing system[128]

2. the rights and duties of collecting, receiving and paying deposit institutions among themselves and with their customers[129]

3. the creation of a consumer transfer technique of limited negotiability, filling the role now served by the cheque[130]

4. the creation of a commercial transfer technique of limited negotiability, similar to the present cheque in its role, but differing from the consumer transfer technique described above in its allocation of risks and remedies.[131]

It could also profitably include:

5. the creation of a freely negotiable commercial transfer technique unencumbered by North American or English notions of defective title subsequent to forged endorsements, and capable of fulfilling both credit and payment functions—basically a modernized successor to the time bill of exchange. This transfer technique should be so defined that the drawer might undertake primary liability. The technique would then also be capable of replacing the promissory note in some uses.[132]

6. the creation of a consumer credit obligation, transferable subject to all defenses arising out of the original transaction, to replace the consumer promissory note. This form could be made the exclusive mode of extending credit at interest between merchants or lenders and a consumer, apart from computer maintained revolving credit accounts and petty transactions.[133]

Legislation on these matters would raise no jurisdictional problems not implicit in the *Bills of Exchange Act*.[134] However, it would be foolish to attempt such legislation without recognizing the effect of the computer and of electronic capture of payment data at remote locations. It is not entirely certain that legislation with respect to paperless transactions of the sort described above is legislation with respect to matters coming within the classes of subjects "bills of exchange and promissory notes".[135] However, federal jurisdiction does not end here.

The anticipated allocation of transactions between electronic and paper forms in the next decade, and the obvious role to be played by the chartered banks in such a system, indicates that such legislation can be viewed as an exercise of the federal jurisdiction over either banking or federal negotiable instruments.[136] The general economic powers of the federal government in the area of payments and national economic policy also must be recognized.[137] What is at stake is the smooth functioning of the national monetary system. Failure to provide a rational legal infrastructure of uniform national application will reinforce regionalization of the economy and produce economic inefficiency.

It is therefore recommended that the study of reforms proceed on conceptual grounds and functional rules that render it legally immaterial whether an "instrument" is embodied in paper or in some other form such as a reproducible electronic signal. Rules for the allocation of loss should be developed that are acceptable regardless of the technique used to transmit the message. Formats having legal consequences—the modern equivalent of "instruments"—should be based upon message content, not upon the data-processing limitations and identification techniques of the eighteenth century.

What is involved in developing a coherent legal regime for the sorts of transfer technique just described? As a beginning point, it is necessary to understand the types of electronic transfer techniques now being suggested. But it seems impossible to predict which of many possible forms of transfer technique will ultimately come to supplant or complement the cheque. Analysis of the issues raised by such electronic transfers must therefore be made in terms of issues of legal and social policy, and the options presented by the new technology.

Impressions of the Future

Within the next decade, it is likely that many new payment techniques will be used. These include:

- a plastic card carrying pre-encoded information, which remote banking machines will use to communicate with a central deposit institution computer. The machines will dispense cash, accept deposits, accept payment of common bills to be charged to the customer's account, and make transfers between chequing and savings accounts.
- the transfer from businesses or government to deposit institutions of pre-authorized electronic debits (analogous to demand drafts payable at a bank, but not necessarily drawn subject to a prearrangement between the *drawee* and the person whose account is drawn upon).[138]
- the transfer from businesses or government to personal accounts in deposit institutions of pre-authorized electronic credits for the purpose of making payroll and other payments, including social allowances such as pensions and welfare.
- instant credit authorization at the point-of-retail sale on a nationwide or international basis within North America, based on a plastic card or a keyboard terminal wired to central computers.
- automatic cheque verification or cheque guarantee, based on use of a plastic card at the retail point-of-sale; if a cheque guarantee, probably associated with a credit card plan through a multiple-service arrangement of the sort recently introduced by some chartered banks.
- the transfer of data on credit card sales vouchers from distant locations by electronic means, accompanied by the disappearance of the vouchers from the monthly statement and use of descriptive billing by major retail credit sources.[139]
- the transfer of electronic tapes containing the information embodied in their paper clearable items between deposit institutions: the pàper will continue to be transferred for legal reasons,[140] but will no longer be processed by each institution to update its account records.
- instant entry of credit sales data from the point-of-sale to consumer accounts, based on a plastic card and a point-of-sale terminal.
- the introduction of electronic funds transfer at the retail point-of-sale, allowing entries based on a plastic card to be made to the customer's demand account at deposit institutions on an instantaneous basis: this service will supersede cheque guarantee and verification. Access to a pre-arranged financing overdraft may be available as an optional or package feature.
- the introduction of services based on push-tone telephones and voice-response from the computer.[141] Transfers between accounts, and bill-payment will be offered. Related services could include prompter files, calculation time

on the computer, and household or tax accounting. Major retailers will also offer services based on other applications of push-tone and voice response to their credit accounts. Small business will receive payment, accounting and calculator services based on the same technology.

In addition to these services, a host of others less closely related to the payment system are possible. For example, if small retailers install electronic cash registers supported by rented computer time, rather than point-of-sale terminals, they could achieve the same sort of economies that major retailers expect to obtain over inventory control, pricing and check out.[142]

Elements for Analysis of Future Developments

These services are only a few of the technological possibilities available in the near future. Analysis suggests that there are roughly 400,000 possible ways to combine the individual technical, legal and business factors involved in making payments. To pick any individual combination of elements at this stage might be quite misleading. But it is possible to talk about legal problems associated with various groups of the factors involved.

At least twelve groups of elements appear to be essential to describe the payment system in Canada. Within each group choices between elements are largely independent of choices outside the group. Some choices within groups are clearly exclusive; but in other groups it might be possible to fit several choices into a workable system.

Table I lists the twelve groups of elements and their constituents. It may be convenient in reading the following material to refer from time to time to Table I.

These elements describe transactions. They are not legal concepts. The justification for an analysis in terms of these elements is that our legal concepts are no longer adequate to describe new developments. Bank credit card plans are legal chameleons, borrowing features from several traditional forms. Yet the success of the plans proves they fill a social need that was previously unsatisfied. Our legal concepts are also too imprecise. The cheque, for example, can be used as a personal withdrawal receipt, third-party transfer order, or fully transferable negotiable instrument. In each use, different consequences are involved.

The elements selected for discussion are common factors in the great variety of individual payment transactions. They may be used to differentiate, compare and describe these transactions. They are freer of historical and present connotations than a legally exact description. A legally exact description of proposed future systems is probably impossible today. It requires accurate prediction of both the system designers' and the courts' response to a very large number of problems that today have only hypothetical solutions. It also requires working with concepts that simply do not fit the proposed transactions without constant qualification.

The elements discussed may also have another use. In a more refined form, they could form part of the analytic structure around which legislative reforms were shaped. Such a renewal of the basic concepts of the law is an essential part of law reform. It is vital when the area of the law concerned—the *Bills of Exchange Act*—[143] has been insulated from judicial reform.

TABLE I

SUMMARY OF ELEMENTS FOR POLICY ANALYSIS

A: *To Whom Payable*

1. personal
2. third party
3. transferable

B: *Access Points*

1. financial institutions
2. remote tellers
3. point-of-sale terminals
4. home terminals
5. office terminals

C: *Network Scope*

1. branch
2. corporate
3. shared
4. utility

D: *Network Control*

1. all banks
2. some banks
3. some deposit institutions
4. some non-banks
5. all deposit institutions
6. communications carrier
7. government

E: *System Settlement*

1. Bank of Canada
2. chartered bank

F: *Time of Settlement*

1. day of transfer
2. instantaneous

G: *Mode of Processing*

1. paper—batch mode
2. electronic—batch mode
3. real-time

H: *Direction of Data Flow*

1. credit
2. debit

I: *When Paid for Externally*

1. immediate
2. deferred
3. optional

J: *When Credited Externally*

1. same day
2. instantaneous

K: *Finality of Payment*

1. legally final
2. practically final
3. consumer charge-back
4. consumer and paying bank charge-back

L: *Cut-off Effect*

1. yes
2. no

ISSUES ARISING FROM THE FUTURE SYSTEM

A. To Whom Payable

The elements grouped under this topic are all concerned with the persons to whom payment is made. Is the technique personal to the user, as a withdrawal receipt is? Is it, like the usual cheque, a third-party order? Or, like a bill of exchange in its original uses, is the technique to be transferable through an indefinite number of parties, the last of whom will receive payment?

Under each element, there are separate problems of identification and lack of authority. Some third-party payment techniques can raise problems of loss of control over the customer's account. Transferable payment techniques present problems of unauthorized transfers in addition to the common problem of unauthorized making. Finally, a question of convenience must be resolved. Should a particular technique be allowed to develop so that it is both personal and transferable, or so that, like the cheque, it functions under all of the elements in this group?

Personal techniques raise two main issues—unauthorized use and erroneous account entries. Traditionally, unauthorized use has taken the form of forgery of the customer's signature. Today it takes the more general form of any use of the identifier that controls the account without the authority of the customer. Erroneous entries cover such things as misposting to the account of someone else's transactions and simple mistakes in mathematics.

Three legal principles have been used to cope with these problems: the requirement of authority, the duty to examine the account, and the defence of account stated.

The requirement of authority forces the banker, viewed as agent, to justify any dealing with his customer's money by some authorization. Any payment of a forgery, and likewise any erroneous charge, is without such authorization. The initial position is thus that the banker, without regard to his negligence, bears the loss of erroneous and unauthorized entries.

The two other principles are introduced to shift such loss to the customer. The account stated principle is used to argue that the bank statement, rendered from time to time to the customer, becomes a conclusive statement of the bank's liability.[144] The account stated principle relies on an inferred agreement about the account, and an estoppel against its reopening, which the law does not unequivocally establish.[145] The financial community has therefore come to depend on a contractual clause in which the customer agrees to examine the account and object to unauthorized transactions. Absent objection, the bank statement is agreed to be conclusive evidence of the state of the account.[146]

As applied, the three principles shift the loss of both unauthorized and erroneous transactions to the customer at the close of the agreed statement period. If the customer has received a benefit from an erroneous transaction, and if he has relied upon the benefit in good faith, the banker may be unable to correct the transaction and reclaim the funds. The barrier may consist in either account stated, where that is applicable, or in an estoppel based on representations contained in the statement.

A new attempt to deal with unauthorized transactions appeared with the use of plastic cards as identifiers. This is the use of a contractual clause requiring the cardholder to bear up to the first $50.00 of loss resulting from unauthorized use until the issuer has been notified of the loss or theft of the card.[147]

Such clauses represent a considerable retreat from the issuer's initial position—which was that the customer bore all liability for unauthorized use. In their present form, the clauses are not unduly onerous. In view of the claim that the $50.00 liability is rarely insisted upon, and is used only to encourage

prompt notification of loss or theft, a smaller limit might be equally efficacious—particularly if the cards are to penetrate further into lower income groups.[148]

Various devices could considerably decrease unauthorized use after loss and theft. Since the decision to use such devices will be made on grounds of cost-effectiveness, it is important that risk of loss and theft of cards be borne by the deposit institutions. Otherwise, the choice to adopt security devices will be based on inaccurate figures.

If truly personal identifiers are adopted,[149] such a policy causes no problems. But if an identifier is not truly personal, there can be difficulties. A code-number identifier is only as secure as the habits—or honesty—of the customer to whom it is given. Serious problems could occur through feigned unauthorized use.

Nevertheless, until truly personal identifiers are economically and technically feasible the necessity of protecting the honest consumer would argue for leaving the risk of all unauthorized use on deposit institutions. In so doing, each consumer will bear part of the system loss—just as he does today with respect to cheques and credit cards. We pay a similar rent to crime in the form of shoplifting to obtain the convenience and net savings of self-service merchandizing.

Such an allocation of risk does not leave the banker hopelessly exposed to fraud. Fraud detection programs can be applied to monitor the pattern of transactions on individual accounts. Complaints against merchants can be similarly monitored, and access to the system can be withdrawn for failure to maintain proper standards. But in the end, the deposit institutions must themselves bear the cost of such system-generated losses, incorporating them in the cost of the services supplied.

The problem of who pays the losses caused by unauthorized use and erroneous entries can be minimized by security and error control features. It is not peculiar to any form of transfer technique, and not affected by the extent to which the technique is payable to third parties or transferable.

Two control features can be used: customer monitoring of statements when delivered, and deposit institution monitoring of transactions as they occur. Some nominal loss should be imposed by the law on consumers to insure that the former monitoring takes place. But the real potential for prevention of loss lies in detecting unauthorized entries as they are made. To encourage development of techniques that will do this, the major incidence of loss in consumer transactions must fall on the deposit institutions.

In business transactions, it is fair to require a higher standard of monitoring by the customer. Often unauthorized transactions are caused by misconduct of the employee controlling the account. The pattern of a business' payments is far less likely to be amenable to computerized monitoring for unusual transactions. One can expect that the author of the fraud will be playing for higher stakes and be more sophisticated than the casual forger using a stolen personal cheque form.

Accordingly, business accounts should be governed on the principle that any disputed entry involving misconduct outside the deposit institution other than forged documents is binding on the business within a reasonable time after the statement.[150] In addition, where the entries form a pattern of misconduct by the business' employees, the deposit institution should be allowed to defend debits for entries including those within the current statement period, if it can show that due care on its part would not have detected the unauthorized entries.[151] Such a rule would place ample pressure on business to use proper control procedures. It would not extend the protection against system misconduct and error found in present account agreements.[152]

The unauthorized and erroneous entry problem is common to personal, third-party, and transferable transfer techniques. Third-party transfer techniques also raise specific problems of their own. The outstanding

factor in third-party transfer techniques is the possibility of collusion between the third-party and the customer (or an authorized user) to defraud the deposit institution. A secondary problem is that the third-party may be half-hearted in enforcing security measures that deposit institutions consider vital.

Reported abuses include the use of A's valid card to pay for travel for X in consideration of cancelling A's gambling debt; the use of A's card by A in collusion with B, a merchant, to effect a sham sale—the transaction in fact being a loan from B to A in which the card-issuer becomes the unwitting collection agency; the use of stolen cards to obtain air line tickets which are sold at discount to unscrupulous passengers;[153] a similar use of stolen cards to obtain such high cost items as cameras, either in collusion with or with the acquiescence of merchants, the goods then being sold, pawned or fenced; and the taking of credit cards as security by loan sharks, who pass the cards on to criminal associates for fraudulent use.

It is sometimes stated that the extreme rigour of the terms found in bank credit card agreements is directed solely to the difficulty of proving fraud in these situations. The broad legal powers taken by the banks are directed, it is said, to making themselves the sole judge of whether such abuses exist—if they do not, the banks settle.[154] If true, such a position is still untenable. The grant of unreviewed legal discretion to a private corporation dealing on manifestly unfair terms cannot be defended. Nor has it ever been demonstrated that the banks have taken no more power than is necessary to protect their interests.

Discretion should properly be exercised in choosing customers—not in settling claims by them. Frauds by merchants and carholders must be organized to be profitable. The better solution is maintenance of records that reveal such frauds as a pattern, and prompt termination of the accounts implicated. Record-keeping on a timely basis will be greatly aided by developments such as the point-of-sale terminal.

If merchant-customer collusion and merchant indifference are seen as problems to be policed by allocation of loss under the card agreements, the banks can use infrequent occurrences to defend extremely harsh general allocations of risk. These problems must be policed by other means.

Third-party transfer techniques that are not initiated by consumers raise a problem of control over consumer accounts. The most likely third-party transfer techniques to be replaced by electronic messages in the immediate future are bank card sales vouchers[155] and certain payee-initiated bill payments, such as insurance and utility accounts. Because already made by a non-negotiable instrument, no presentment of paper to the payor institution is required.

Even without installing electronic terminals at the point of sale, banks could transcribe credit card vouchers to magnetic tape at regional centres and handle only the data from those points onward.[156] Similarly, deposit institutions could prepare or receive taped debit entries from major customers and transmit the data to consumer accounts.

The former transaction is consumer initiated. The only issues raised are the adequacy of the descriptive billing and the right of the consumer to call for a full itemization of the transactions in question if he disputes the bill.

The latter transaction is not consumer initiated. It involves the collection from consumer accounts of messages which do not carry their own authority to pay. To be strictly protected, the payor institution should hold proof of standing authority from its customer to pay such debits. However, some legal structures, including those in use in Canada, dispense with consumer authorization for such payments. The payor relies upon the payee's representation of authority and a supporting indemnity agreement.

The use of such a single pre-authorization results in loss of control by the consumer over his account.[157] Loss of control is not a problem with third-party transfers generally.

It occurs only when a creditor originates debits, or a debtor originates credits. In the latter case, it is probably important only in cases of an insolvency or threatened insolvency.[158] On a day-to-day basis it is loss of control over debits initiated by creditors that is seen as threatening by the average man. A partial solution to some aspects of the control problem is the creation of an automatic self-help remedy for the consumer.[159] The control issue is of great importance. Loss of control over the personal bank account is threatening to the individual. The issue will affect large groups of consumers. Perhaps most important is the power of the deposit institutions as a group to impose uniform terms governing control on consumers. Government monitoring of developments in the use of single pre-authorization should take place.

In addition to the problems of collusion and control, third party techniques raise an issue of convenience. It appears likely that any third-party technique will be usable for personal payment as well. Both the cheque and the bank credit card are so usable. Except for the cheque, the tendency seems to be to restrict the personal use of a technique with third-party capability to direct transactions with deposit institutions. This tends to decrease convenience for the consumer; but if the need for cash decreases markedly or if cash dispensers proliferate, it may no longer be necessary for retail merchants to fill their present role as the housewife's bank.

The immediate future should see the widespread use of a personal technique—the cash dispenser—on a corporate or shared basis in most Canadian cities. In the present state of the art, such a technique is personal only in the sense that a personal code is given to the cardholder. If he so desires, he can give card and code to another. A third-party technique such as a credit or debit card could also operate cash dispensers in a personal mode, providing a convenience feature.

The third-party transfer techniques likely to be replaced by electronic messages in the immediate future are not card-based, and have no cash dispenser feature. Whether cash dispenser machines coming into existence will be integrated with one or more of the other card-based techniques being brought forward is unknown at this time. However, technology for such an integration is readily available.

Transferable techniques present further problems. Such messages must carry the identifier of each transferee. Questions of authority to transfer can arise between transferees. Such a technique in electronic form would require a much more complex message than the cheque or credit voucher does.

It is unlikely that there is any consumer need for a fully transferable technique. Such electronic instruments, if created, would probably fill the role of securities or money-market instruments such as the banker's acceptance, or of specialized commercial transactions associated with the financing and transport of goods in international trade.

The possible development of such transfer techniques should be monitored. Work in these specialized areas may be desirable in the foreseeable future. The money market instruments are closely linked to work now underway with respect to electronic securities depositories;[160] the commercial instrument would obviously require closely integrated international action.[161]

Further study should adopt the following as working premises. First, apart from nominal charges to consumers, the risk of unauthorized consumer transactions and erroneous entries should be borne by deposit institutions. Such risk may be borne by business accounts. In no case should a consumer or business bear any loss caused by want of due care on the part of a deposit institution in maintaining a payment account. Second, the possibility of consumer-merchant collusion to defraud deposit institutions should not be accepted as a justification for general principles of allocation of loss. Third, the issue of adequate safeguards for non-consumer-initiated transactions on consumer accounts deserves careful study. Attention should be devoted to the problem of conse-

quential dishonour through improper debits and the failure to make timely credits. The desirability of single authorization schemes should be evaluated on the basis of consumer reactions, as well as on technical grounds. Creation of an automatic self-help remedy for the consumer against improper debits is probably necessary. Fourth, the question of convenience in multiple applications of a single card should be left generally to commercial judgment. No unnecessary barriers to such use should be created. Finally, the study should not concern itself with truly negotiable electronic transfers at this time.

B. Access Points

Today's most common transfer technique, the cheque, is so versatile that it can be used in almost all payment transactions. But electronic transfer techniques would be more specialized. The points from which these techniques would give a user access to the electronic network linking deposit institutions are an important element in describing the techniques. Five sorts of access points seem likely in the foreseeable future: deposit institutions, remote tellers, the retail point-of-sale, the office, and the home.

Deposit institutions are the obvious minimum access. The widespread use of on-line savings accounting through teller operated terminals has been the first public appearance of computerized banking. Deposit institutions already make remote data entries within their own corporate networks. They are considering their legal relationships on a contractual basis with outside firms that would like to submit transfers on magnetic tape for processing within the institution and for clearing. Technical standards are already developed for such exchanges of tapes.

Exchanges of magnetic tapes are a very slow means of handling data. Such exchanges will be replaced in many applications by wire or other electronic links capable of instantaneous transmission. Such links between deposit institutions or with their major customers raise problems of computer security. Deposit institutions are rightfully cautious about direct interaction between their own computers and "outside" equipment of any sophistication. There have been a number of incidents of pirating of data that could have been disastrous if the data concerned had been "money".[162]

Remote tellers are devices that perform simple teller-type functions after hours or off bank premises. They accept deposits, make inter-account transfers, and dispense cash. Remote tellers can be distinguished from wired computer-to-computer access. A remote teller performs automatically simple teller functions. It makes inter-account transfers, such as savings to chequing. It accepts deposits (subject to proof) and dispenses cash. It may possess a limited third-party payment feature—limited to common bills of the sort now payable at deposit institutions. The capability of a remote teller to transmit information, even on-line, is so limited that it represents no danger to the deposit institution computer.

Remote tellers do pose some interesting questions of shared networks and joint use. Since they are used directly by consumers, substantial duplication could be avoided by shared or utility organization of remote tellers.[163]

Point-of-sale terminals are devices designed to capture financial data electronically at the point of retail sale. An electronic cash register is a more versatile device which also captures inventory data for the retailer's use. Such machines are the modern descendants of the cash registers and credit card imprinters formerly used to capture payment information.

Point-of-sale terminals are a logical extension of the credit card. Fraud and bad credit losses from use of such cards could be greatly reduced by computer comparison of cards presented at the point of sale with the issuer's total current list of unacceptable cards. Such a task is impossible manually, difficult and costly by telephone to a computer centre, but simply done from a remote, card-operated computer terminal.

Once a basic card-operated terminal is placed at the point-of-sale, its capability can

be rapidly expanded. Relatively inexpensive devices are already used to capture credit or debit data at the point-of-sale. If properly supported they are capable of operating on a real-time basis. Substantial numbers of cheque and credit card transactions could be eliminated by such terminals. However, to achieve their full potential, they must operate on a real-time basis—tied by wire to the deposit institution computer network.

Electronic cash registers are devices that are designed to perform sales and inventory control functions for retail merchants in conjunction with a supporting computer. Their significance is that they are rapidly penetrating the same markets in which point-of-sale terminals linked to deposit institutions would be economically most feasible.

The electronic cash register may be built to coding standards based on a technology that differs from that adopted in development of point-of-sale terminals. It has been suggested that this can be overcome by linking deposit institution and retailer systems at the level of the retailer's computer.[164] This poses the same sort of security problems as a direct link between computers when an outside corporation submits bills for electronic collection and has the additional difficulty that there is no alternative to real-time communication with the point of sale to achieve full advantage from the deposit institution's point of view.

Another possibility is to modify the retailer's electronic cash register to achieve capability in both technologies. But retailers foresee substantial increases in employee productivity at the check-out point, and are unlikely to sacrifice savings at that point to promote use of a payment card that is incompatible with their own system and in competition with their own in-house credit plan. Even if deposit institutions were to bear the full costs of installation, they would encounter opposition based on decreased productivity at the check-out station.

There are serious barriers to extending the entry-point to the point-of-sale from a commercial point of view. From a legal point of view, point-of-sale entry also raises difficult questions. These questions have to do with the "cut-off effect" and "final payment" elements of payment transactions.

Shared terminals or the use of terminals owned by deposit institutions on merchant premises can be expected to confuse the consumer. In such situations, with whom does the consumer deal? What are his reasonable expectations?

Shared terminals may also raise issues of competition policy, depending on the manner in which the groups providing the terminals or terminal service function. Questions of the right of a retailer to connect his own terminal to the network must also be ultimately faced.

Home terminals are a promising access point to many computer facilities, not merely the payment system. Although full exploitation of possibilities is probably a decade or more away, initial experiments with push-tone telephones and a voice response system are quite promising from a technical point of view.[165] For security reasons it may be desirable to restrict the payments applications of home terminals to small numbers of accounts, perhaps by some system of pre-authorization.

Office terminals pose a host of legal issues. Most of these concern the sorts of services deposit institutions can offer their customers. These issues involve competition policy questions outside the scope of this paper. But the use of an office terminal to make business payments raises difficult security problems. The number and variety of payments made by businesses, and the necessity to delegate the paying of bills to employees, complicate the problem of establishing adequate controls over use of such office terminals.

Today there is considerable fluidity in business planning for remote terminal use. Is it better to attempt to define the services offered by deposit institutions by law, to create a regulatory discretion, or to issue policy statements from time to time? All three are possible ways of influencing the kinds of

services that will be offered through remote terminals to customers of deposit institutions.

Consumer convenience should also be considered. If one simple identifier, perhaps a card, can be used at a variety of access points, the chance of producing a system consumers like and will use increases. Volume use is the key to feasibility of electronic payment transfer techniques.

Further study should consider the appropriateness of the risk allocation agreed upon between deposit institutions and users of exchanges of magnetic tapes. It should monitor and consider the legal implications of competition policy concerning remote teller devices and point-of-sale terminals—particularly the implications of shared networks for such devices.

At the point-of-sale, further study should monitor the accommodation being reached between the deposit institutions and the retailers on standards and technology. It should consider the effect on consumer expectations of the use of trade names associated with deposit institutions in seller advertising or on seller-operated terminals.

Home and office terminal proposals should be monitored, and phased into the study at a timely stage. These proposals are likely to mature somewhat later than those for remote tellers and point-of-sale terminals. The impact on consumers of cut-off effect and finality of payment is discussed later in the paper. But the study may need to consider that if general principles governing these matters remain unreformed, the access point may be the most effective place for disclosure to consumers that use of certain payment techniques involves a forfeiture of their most useful remedies in the event of disputes.

Finally, as the course of business development and government policy clarifies, the study should examine the legislative format within which deposit institutions function for the purpose of evaluating whether that format accurately expresses the form in which institutions are developing. In particular, the scope of the expression "the business of banking" will require continuing evaluation.

C. Network Scope

In thinking about networks for transmitting money transfers, it is useful to separate questions of who may use the network from questions of who may exercise primary control and receive the benefits or losses of ownership. The elements of network scope are concerned with rights to use networks; the following group of elements—network control—are concerned with rights of primary control and ownership.

Access points, discussed above, are where users might put messages into the network. Network scope determines where data can leave the network. One output point gives a branch or member technique; if the output is bank-wide or cooperative-wide the technique is termed corporate. Competing institutions can use a shared network, while a network sending data for all institutions on a system-wide basis is described as a utility.

Case law with respect to negotiable instruments developed at a time when the records of banks were maintained, of necessity, at the branch level. For most payment purposes, a branch of a bank is still regarded as a separate legal entity. Among the non-banks, the pattern has been either to imitate banks, or to organize on a legal unit basis and then federate into leagues or centrals.

Issues of network scope require balancing financial competition policy, convenience and protection of payments in transit. Even with the technology currently installed, branch level scope is largely obsolete. Current efforts by banks and even federated non-banks are aimed at achieving an organization-wide corporate network.

The potential economies of scale available with existing but uninstalled technology appear to be so great that shared facilities will be forced on smaller institutions. Whether the economies are so great that they will require organization of the transfer network into a single public utility is an unanswered

question. Creation of such a utility network might restrict innovation severely. On the other hand, the savings generated might be so great that a utility network could support a far greater variety of transactions than a shared or corporate network. Numerous possible solutions exist. The scope of the present chequing system is that of a utility while the two bank card systems operating in Canada have separate shared networks. Shared and utility networks raise questions of ownership and control which are independent of network scope.

Network scope is greatly influenced by the very high start-up costs of electronic payment techniques, and by the need to generate large numbers of electronic transfers quickly in order to make the network pay its way. It is also influenced by purely technical considerations such as systems incompatibility. Suppliers of computer elements can engineer their systems in a manner that will prevent their economic use with a competitor's equipment. Such a form of market protection would guarantee competing shared networks for the economic life of the equipment if major banks installed incompatible systems.

Although convenience is a factor, we are already accustomed to carry a pocketful of plastic cards. Achieving satisfactory protection of payments in transit in shared or utility networks may require minor adjustments to the deposit insurance system. But the consumer interest here can be adequately protected by a coordination of solvency standards and insurance, coupled with rules determining the point at which the right to the deposit (and hence the benefit of the insurance) shifts between originator and payee.

The most difficult issue in network scope is one of competition policy. How much additional investment is acceptable in order to substitute an oligopoly for a monopoly? Not only financial competition policy is involved. Utility or shared networks need not be controlled by deposit institutions.

The issues presented by the choice of network scope are currently under intensive study by government. Further study will hopefully be able to build on settled policy in this area.

One recommendation already made—that of non-discriminatory access to clearings and all other payment exchanges for non-banks—is clearly relevant to the scope of any electronic network. But apart from that recommendation and the issue of participation on equitable terms in the administration of the clearings further study should not focus on issues of competition or cooperation in the creation of the network.

D. Network Control

A network is easy to talk about; but hard to define. As a minimum, it is a computer capable of routing messages from access points to destinations at one or more deposit institutions, and the rights to use communications circuits to get from the access point to the computer and on to the destinations. But in its mature form, the network may have total capabilities beyond the requirements of any single group of user institutions. Even at an early stage, it is likely that the network will be capable of supporting a variety of transfer techniques, and that it may concern itself with financial transfers apart from deposits.

Definition of the boundaries between the network and deposit institutions is the burden of regulatory policy for the next decade. There are important technical and commercial constraints on the rules for network operation. Network control should not be visualized as the power to write the rules. It is instead the power to create the network under a set of rules arrived at by deposit institutions, carriers, and government. It is also the right to take the return from network investment.

The control of a transfer network need not be co-extensive with its scope. For example, a network servicing all deposit institutions on a utility basis could be controlled by banks alone. If the principle of non-discriminatory access to the clearings is taken as established, and if any attempt to discriminate would provoke federal action against the banking community, the existing clearing

system may be viewed as a bank-controlled utility servicing other deposit institutions.

Control by all banks is one possibility for the future network. Proposed amendments to section 138 of the *Bank Act* would expressly authorize agreements between banks respecting shared facilities, research and development, and utilization of transfer methods.[166] Such agreements, which are not subject to formal governmental approval, could effectively replace the provisions contained in the clearing rules.

Agreements between other financial institutions are to be subjected to the general law governing competition. The status of an agreement between banks and one or more non-bank institutions is not free from doubt. The proposed section 138 would clearly permit agreement between banks as a group with respect to services rendered a non-bank, and probably subject agreements in a mixed group to the general law. Non-banks might be required to approach any transfer system through a servicing bank on the ground that the combination of the *Bank Act* and the *Combines Investigation Act* makes it impossible to service them lawfully in any other manner. Whether the servicing would consist of access to competing shared systems or a single utility transfer system is not dictated by the proposed legislation.

The fatal flaw in existing competition policy in the financial sector is the use of an inappropriate legal tool. The *Bank Act* cannot regulate the development of a unified national payment system in a non-discriminatory manner. As long as the *Bank Act* is used to avoid grasping the jurisdictional nettle, the federal government can offer non-banks nothing more than protection against open and notorious discrimination.

The creation of an electronic network for the transfer of messages between deposit institutions will require investment on a large scale. Given the present role of the Canadian Bankers Association, the present clearing system and the proposed section 138 amendments, one obvious policy choice for network control would be control by all banks. This choice would yield a single network, evolving out of the existing clearing system, in which non-banks acquired rights of use by contract with the controlling group or with individual banks.

A variation of this result would occur if equipment that was technically incompatible with other banks' equipment was installed by a major bank. Competing shared networks would then exist, which might find it profitable or necessary to invite non-bank participation. The end result would be competing networks controlled by some banks or some deposit institutions.

Considering the wealth of prospective participants, their share of the market and probable competition a national network comprising some non-banks or all non-banks can be dismissed as impractical. However, the growth of such a network in Québec under the sponsorship or control of the Québec Federation of the Caisses Populaires Desjardins would appear to be a distinct possibility in the absence of a national network based on equitable principles of operation and control.

A national network, open to all deposit institutions as members with control rights poses the real issues. Given the economies of scale mentioned in connection with the discussion of network scope it is likely that the real policy choice is trifold.

Should the national electronic transfer network for deposit institutions be owned and operated (1) by deposit institutions; (2) by communications carriers; or (3) by government? If either of the private ownership alternatives are chosen, what form should government regulation take? And what are the boundaries between network and deposit institution?

Development of a network controlled by deposit institutions would be aided by creating a uniform legal framework for its structure. This could be facilitated by recasting the proposals for section 138 of the *Bank Act* in terms applicable to all deposit institutions, and returning them to the *Combines Investi-*

gation Act. Such a change need not alter the basic division of responsibility for enforcement of regulatory and inspection requirements that presently exists. Development of an efficient network under deposit institution control would also require changes in carrier policy concerning line sharing, resale of services, and foreign attachments. This policy is in some instances forced by provincial statute.

If it is decided to place such a network under the control of communications carriers, very difficult regulatory questions would be posed. One of the factors favouring carrier control is that the financial message traffic to be carried by the network is a key—probably the key—load upon which a national information handling network can be built. Without the financial data, a useful system may never be economically feasible.

On the other hand, the requirements of the deposit institutions are such that they are most unlikely to accept dictation from a carrier regarding the system's characteristics. The regulatory structure must therefore comprehend the technical problems of both the carrier and the deposit institution system. It must allow for commercially sound accommodations of conflicts of interest that are bound to occur.

The record of communications carriers and their regulation in this regard is not a happy one.[167] The "foreign attachments" problem is implicit in any deposit institution network. Unless existing restrictions on such attachments are relaxed, it is most unlikely that such things as remote teller service or point-of-sale terminals will appear in the near future in Canada.

An additional problem is posed by the manner in which regulatory jurisdiction over carriers is presently exercised. There is a system of divided federal and provincial jurisdiction—based on the source of the carrier's charter. Since any national payments network would involve both local and national message traffic, and would require uniform standards, an impressive degree of coordination and cooperation would be required on the regulatory level.

It has already been suggested that the existing clearing system requires substantial modifications, and that the Bank of Canada should be given responsibility for regulating clearing standards and promoting a more general discussion of payment policy issues. These responsibilities in an electronic environment would require close coordination on a technical level with regulation of the carrier's rates, equipment and message specifications, and "foreign attachment" requirements.

The possibility of a government-operated network seems unlikely. The arguments are those for and against the nationalization of any public utility. Such arguments are political, rather than legal.

In summary, issues of network control are a composite of factors raised by the scope of the network and of public policy. The most serious legal issues involved are those of defining the new statutory framework required. This process of redefinition will be needed whether the chosen network is controlled by some or all banks, by deposit institutions, by a communications carrier or by any other of the possible choices.

The primary decision among these choices is not based on legal considerations. However, once that decision is made further study should confront the legal issues raised by the regulatory framework selected. In no case are the existing statutes adequate to accommodate the new policy.

E. System Settlement

Systems for the transfer of money must provide for some means of ultimate payment in satisfactory credits. Among individuals, the obligations of deposit institutions are generally satisfactory. But for the institutions themselves, such obligations amount to the substitution of one promise to pay for another. Between deposit institutions, settlement by draft or deposit account is adopted for temporary convenience until a final settlement can be made.

Settlement in legal tender leads lawyers to quote poetry, but is commercially inconvenient.[168] Settlement by set-off will be acceptable only when the party receiving such settlement is satisfied that the account will generally stand in his favour. It thus requires a reserve balance or an adequately protected line of credit held by the presenting party. Settlement by set-off is used by non-banks dealing with the banking system.

Settlement in third-party deposits—that is by orders issued by institution A upon institution C and payable to institution B—is also acceptable in some cases. Among members of credit union federations, or between such federations, this technique is used. The third-party who holds the deposits may be a credit union central, or it may be a chartered bank.

The chartered banks themselves settle in third-party deposits, as does the only existing Quebec Savings Bank. But in their case the holder of the deposits is the Bank of Canada.

The present settlement techniques are thus quite varied. Introduction of new techniques of transfer seems likely to increase the variety of means of settlement, although no doubt ultimate settlement will continue to be at the Bank of Canada.

Public expectations must be considered in deciding what the effect of different means of settlement should be. The consumer does not now distinguish cheques and non-bank orders. It is unlikely that the consumer will distinguish between banks and non-banks in the use of any future technique.

Government policy promoting the non-discriminatory treatment of non-banks in clearing should be extended to exchanges of payment data which replace the clearing. This may result in an increase in the variety of means of settlement.

It is important that neither existing nor future variations in settlement techniques be made the pretext for complicating the legal treatment of transfers used by consumers. If settlement techniques approved as non-discriminatory would impose risk on the consumer or on a collecting institution unless separate legal status were given the transfers being settled for, it is the responsibility of government to accept or cover the risk. Government controls the power of institutions to engage in the deposit and payment business, and government also can control the determination of which settlement techniques are non-discriminatory. Any undue burden of risk imposed on government by making the law of payment transfer correspond to public expectation can be met by control of the terms and conditions upon which such business can be done, by changes in the approved techniques for settlement, or by insurance levied from the institutions as a group. The choice of means is for government; but the responsibility to the consumer is clear.

A future system can be foreseen in which, although ultimate settlements are made at the Bank of Canada, a wide variety of other techniques are used. The development of such a system must, however, permit the removal of legal distinctions between bank and non-bank instruments and transfers from the point of view of consumer users of the payment system. The development must also be continuously monitored to assure that settlement techniques are truly non-discriminatory when considered as part of the total handling of the instruments or transfers involved.

Further study should be directed towards isolating in the context of particular transfers and their means of settlement the consequences of requiring identical legal treatment for non-bank and bank transfers. When these consequences entail risk for collecting institutions, the study should attempt to define the scope of that risk.

F. Time of Settlement

Under existing practices, time of settlement has not been a serious problem. Some pressure has existed for allowing delayed settlement for items which cannot be machine processed—e.g. counter cheques. However, the present system is based on settlement between deposit institutions on the day of transfer.

The present pattern of settlement is based on the batch-processing of paper. Institutions accumulate their items daily, process them in a batch that night, and exchange and settle for them the next day. In a system based on the batch-processing of electronic transactions, this sort of routine might still be followed. In the short term, settlement on the day of transfer will probably continue to be the rule.

Over the long term, deposit institutions—or at least major banks and non-banks—will acquire the capability to clear transactions on a real-time basis. Such a capability would allow acceleration of settlement by as much as a full day for some transactions.

The monetary, legal and security features of a real-time transfer system will be better appreciated as experience is gained with pure electronic transfers. A continuing effort to monitor these developments should take place. In the period of transition between batch and real-time processing of various transactions, convenience may favour retaining uniform settlement patterns even though some of the steps of the clearing process have been accelerated.

Further study should monitor evolving settlement practice to assure that float is not artificially created.[169] Rules governing settlement should promote efficiency. They should also be equitable to both institutional participants in the payment system and users of it.

G. Mode of Processing

Three modes of processing items can be distinguished. Items for which the paper instrument is legally necessary are processed in batch mode today. The cheque is an example. Items for which the paper is not legally necessary will soon be processed electronically in batch mode. Examples are bank credit card vouchers, pre-authorized insurance payments, or payroll transfers. Finally, items for which the paper is not legally necessary may in the future be processed in real-time, that is by instantaneous interaction between the computer holding the deposit account and a terminal or computer sending the item.

We presently operate in a paper-based system. Some of the paper is legally necessary; some is not. The processing of paper is already electronically aided.

Processing of transactions in which paper has no legal status can be accelerated by remote entry of the payments concerned into the computer that performs the record-keeping function. The subsequent disposition of the paper voucher is then a business matter, subject to the requirements of the law of evidence.

Where the paper has legal status as a negotiable instrument, such remote entry is not possible as a matter of basic law.[170] It may be possible to construct a chain of indemnity agreements and agency arrangements to minimize this problem, but the resulting structure is cumbersome. As an effort to adapt existing practices to a radically new technology, it resembles the curious early automobiles in which the driver sat in a raised coachman's box at the rear—to better control the non-existent horse.

The use of paper makes it impossible to use real-time processing. Only a few functions—credit authorization is one—are likely to be placed on a real-time basis immediately. But in the longer term it seems likely that at least the removal of funds from the consumer's account in a point-of-sale transaction will be performed on a real-time basis. Such a removal either decreases the balance of money on deposit or decreases the portion of a line of credit available to be drawn upon.

These transactions can be structured so that they are irreversible, or so that they are conditional upon a right to charge the transfer back in certain situations or for a specified time period. If the former choice is made, the techniques used to make the transfer must pay special attention to problems of security and authority. Either technical or legal protection for the cardholder must prevent unauthorized persons—whether or not in possession of a valid card—from completing enforceable transactions against the cardholder's account. If the latter choice is made, it is necessary to develop rules gov-

erning the effect of these contingencies on third party claimants to deposit balances.

The use of batch-processing on a daily basis fits neatly into present settlement arrangements. However the use of real-time processing would affect the present distribution of float. The paying bank would be able to process the charge to its customer immediately but settle later, thus receiving an advantage, unless the time of settlement were adjusted.

The mode of processing has created legal issues by imposing constraints on the kind of information available, and the speed at which it becomes available. If point-of-sale cheques are processed over a three to five day cycle between issue and payment, the point-of-sale transaction is a short term credit transaction treated as cash.[171] If debits from the point-of-sale are processed instantaneously and irreversibly to the payor's account, from the payor's view the transaction is payment in money—either by transfer of a deposit or by a simultaneous loan and transfer.[172] But whether the payee can treat the payment as cash depends on his legal and financial relationship with the institutions involved.

Real-time processing alters the commercial feasibility of checking credit cards against lost, stolen or over-limit lists. It allows such lists to be current, available in full to every seller and updated after each purchase. It allows the use of security codes that are not incorporated in the card and that are therefore impossible to decode or alter through possession of the card. By changing so radically the kinds of information that can be instantaneously exchanged between the point-of-sale and the deposit institution, real-time processing makes it possible in many cases to allocate risk to the deposit institution without requiring that institution to become an insurer of the transaction.[173] Viewed in another way, it allows an insurer's liability to be imposed for all transactions by reducing the actual risk to manageable proportions.

Another consequence of the increasing use of batch or real-time processing is more subtle. As a practical matter, processing already occurs almost entirely by electronic means. It may be questioned whether procedures involving high cost manual processing imposed solely for legal reasons will be adhered to by deposit institutions in the future.[174] If this is so, the institutions will be functioning as insurers in respect of the matters involved, and the relevant law will be reduced to an elaborate fiction.

In less clear cut cases, the deposit institutions are restrained from increasing their own efficiency and that of the system by formal characteristics of paper transfers. These include the duty of presentment, matters associated with post-dating, the extent of tranferability allowed to cheques, and the evidentiary status of various records of transfer.

Because paper was the only form in which money could be conveniently transferred, the law has for many years placed much weight on the crime of forgery as a means of protecting the payment system. The essence of forgery is the false and fraudulent making of an instrument. Forgery is commonly proved by comparison of handwriting, which requires practically that either originals or facsimiles of the instrument be retained as records. The crime of forgery was useful because it allowed the punishment of unsuccessful frauds. When the fraud succeeds, there are alternative crimes available for the prosecutor. If certain kinds of records are retained chiefly to aid prosecution for forgery, the record-keeping may cost more than the crimes. An offence serving the same purpose as the crime of forgery, but placing less emphasis on the instrument, might then replace forgery in protecting payment transactions.[175]

Further study should consider the extent, having regard to the probable existence of techniques that function in both batch and real-time modes, to which the insurer's liability for unauthorized use and error is a proper charge on the deposit institutions alone, and thus not compensable by passing on to the customer.

Such study should also consider the extent to which deposit institutions should be authorized to pay instruments before presentment, to file paid cheques centrally on micro-film or in other retrievable facsimile form (destroying the originals without return to the customer), and otherwise to separate the financial message from the paper on which it is issued. This aspect of the study would necessarily address the issues of what should constitute legal proof of payment. Such evidentiary questions entail a review of the relevance of the crime of forgery in the new payment system.

H. Direction of Data Flow

Data used in making payment can be transferred for collection—as a debit—or with payment—as a credit. It is not necessarily true that data flowing from payor to payee institution produces a credit transfer. Today data flowing from payor to payee institutions is accompanied by drafts in settlement. Such drafts are not equivalent to a true credit transfer in the event of institutional insolvency or in their effect on float. But when data flows from payor institution to payee institution, true credit transfers are possible.[176]

For example, the payor institution could accompany each group of transfers with a packet of cash. This is obviously awkward and risky—but it would be a true credit transfer. The payor institution could settle electronically in real time by transferring Bank of Canada deposits to the payee institution's credit, or by a charge to its own account with the payee institution. Thus, a true credit transfer could be produced. Direction of data flow has consequences which are not technological.

In any system that does not provide instantaneous execution of and settlement for transfers of funds, the direction in which data flows is potentially important. It is possible, through focusing on existing rules, to attach a great deal of legal weight to the direction of data flow in a true credit transfer. For example, one could argue that credit transfers were paid at their inception, were thereafter irreversible and irrevocable, and that the payee became, from the inception, a creditor of whatever institution was accountable for the transfer. Such a legal relationship would be totally different from the debit transfer situation, where the payee is not irrevocably a creditor of even his own institution until the instrument is collected.

The example mistakes traditional views about payment for unalterable truth. It may be far more useful to create a system in which the direction of data flow has no legal consequences at all.

At present, transmission of data in either direction—credit or debit—is not instantaneous. There are time intervals between the charge to the payor's account, the transfer between institutions, and the credit to the payee's account. There may be intervening transfers between institutions in some cases, and it may be legally significant that the payee has not received notice of the payment.

With cheques, these time intervals should be read backwards. The payee usually has authorized the deposit. The payor can by use of a "stop order" block the payment unless it has been charged to his account. The consequences of institutional failure during the collection process are complex, but usually fall on the payor since the cheque does not normally discharge his obligation until paid.

In a credit transfer system as described in the example, the payee need not have authorized or know of the transfer to his account. No "stop order" would be possible once the payor's institution had commenced the transfer. The consequences of an institutional failure would generally fall on the payee, since it is he who would hold the deposit obligation. But the underlying debt would not necessarily be discharged unless the payee had authorized the payment. Without authorization loss resulting from failure would fall on the payor.

At what point in the transfer should the payor lose the right to block or recall it? To whom are the institutions handling a transfer responsible—payor or payee? When does "payment" occur for the purpose of dis-

charging the underlying obligation of payor to payee? Who bears the risk of institutional failure?

Traditional solutions to these questions have focused on when the payor's account was finally charged. This was also the last step in the traditional debit transfer of bills and cheques. The problem of failure to collect has been met through various devices.[177] These devices in large measure protect the institutions involved in collection of the transfer. To the extent they are so protected, it is possible from a commercial point of view to treat the cheque and similar instruments as payment on condition subsequent. Since this is done, producing identical treatment of debit and credit transfers might be easier than would first appear.

Direction of data flow is an important technical aspect, particularly in the transition to electronic payments techniques. Changes in direction of data flow are most likely to occur in situations in which a large institution makes numerous payments on a recurring basis. Possible transactions would be payroll payments, social payments by government, or divided payments.

Changes in direction of data flow do not necessarily imply a change in the originator. For example, payroll would still be originated by the employer. Only its route to the employee's account changes. Nor would a change in the originator necessarily involve a change in data flow. A direct debit of a utility bill or a department store bill is still a debit, although the originator is now the billing company.

If the push-tone telephone becomes sufficiently common in a region, reversal of data flow for even consumer and small business bill paying becomes a realistic possibility. This development, however, is probable only in the long term.

How should further study deal with the direction of data flow? Direction of data flow will be technically important in implementing techniques. However, it may be that some of the techniques created have relatively short life-spans—after which their replacement by an alternative technique with reversed data flow is feasible. Major legal rules should not be based on the direction of data flow.

Where rules based on direction of data flow are necessary, they should be restricted to inter-institutional relationships. Barriers to reversal of data flow in payment transactions should be reduced as far as is possible. The direction of data flow should be irrelevant to end-users of the payment system and of commercial, rather than legal, importance to the participants in the system.

I. How Paid for Externally

A payor must settle with his own deposit institution for the payment transfers he makes. This process of *external* payment or settlement must be clearly distinguished from the system settlement described earlier.

A consumer typically "pays for" his cheques by allowing the bank to offset them against his deposits. He "pays for" payment in currency by delivery of the currency. He "pays for" a purchase made by credit card through incurring a future liability to pay the card issuer which is offset against his line of credit. Cheques or credit cards may be combined with other services of deposit institutions to offer further choice in how the consumer pays for transfers from his account.

For consumers, these choices concerning the means of paying for payment transfers are a relatively new development. For business, such choices have existed for some time. But business can be expected to understand, and bargain for, the consequences of various means of paying for transfers. For business, free choice in a competitive market can be achieved through competition policy. Since the consumer does not understand the consequences of choice, and cannot bargain intelligently, competition policy cannot protect his interests. Intervention in the market is necessary.[178] The basic alternatives are disclosure or legally mandatory account terms.[179] Before confronting those alternatives, it is necessary to understand how the means by which a person pays for the making of a payment transfer can affect both

his substantive rights and his practical remedies.

A payor does not always pay his original creditor directly. He may obtain credit from another person to pay a seller. Or he can obtain credit from a deposit institution. The source of credit to finance a purchase or other transaction—whether that source is also the seller or not—may be called a financier. The advantage of this term is that it focuses on the actual use of credit—not on whether the transaction takes the form of a sale, a loan, or some other means of getting goods or services now and paying later. Whenever a person uses credit, he deals with a financier. The financier may or may not be the supplier of goods or services. For historic and constitutional reasons, the law has often paid undue attention to the formal means of payment and neglected the substance of the transaction.

Three choices are available for the means of payment between payor and financier: immediate (cash) payment, deferred (credit) payment, and optional payment. In optional payment, the payor is given a choice between cash or a short-term credit and a system of instalments prepayable at any time. Formally, the credit may be short term and extensible at will or long term but prepayable; in substance, the payor, subject to a periodic minimum payment, pays as and when he wishes. Optional payment is a feature of revolving department store credit, bank credit card plans, and cheque guarantee plans.

Choice of a means of payment—immediate, deferred or optional—can radically affect the rights of the consumer and his bargaining position in event of suit. First, if the payment of his financier has not yet taken place, he is able to put the burden of suit on the financier by withholding payment. Second, against some kinds of financiers the consumer has rights which the law denies to non-consumers.

These effects can be illustrated in a sale of goods to a consumer, although the basic problem is the same whether goods or services are purchased. Under the law of sales, the buyer has the right to reject seriously defective goods. This right persists after delivery. Its exercise terminates any claim of the seller to even an adjusted price. However, if the price has already been paid, the consumer buyer must bring an action to recover it. There are usually no legal barriers to this action, but as a practical matter it is a useful remedy only when the goods are expensive. If a seller receives cash payment he is therefore in a strong tactical position when disputes arise.

By contrast, so long as credit is extended, the buyer has the tactical advantage. He can stop his cheque. He can refuse to pay his account or his note. When the seller sues, the buyer can defend on the basis of the defect in the goods. Even if the defect is not serious enough to give the buyer a right to reject, the decrease in value owing to the defect is set off against the price.

How can a seller protect himself? He can deal, expressly and conspicuously, on "all sales final—cash payment" terms. Such sellers are unlikely to do much business unless they offer significant reductions from the market price. He can attempt by contract to exclude the consumer buyer's right to reject; but such an attempt is liable to fail because of the doctrine of fundamental breach unless the court believes the buyer genuinely agreed to forego his right to reject. Or the seller can accept the consumer's tactical advantage, and conduct his business accordingly.

An adequately capitalized seller seeks cash payment from an honest buyer for two reasons: to meet the possibility that the buyer is a poor credit risk and to enhance his tactical position in the event of a dispute over the quality of the goods. What is the effect of the seller's accepting some other means of payment? Until he is paid, the seller carries the risk of credit and dispute. For a normal cheque, the risk period is probably less than a week. For term credit, it is the term; for instalment credit, the risk declines over the term. Where optional payment is used, the seller must be able to absorb fluctuations in his customers' payments.

If the seller carries his own credit, the means of payment affects the burden of suit and the credit risk. It cannot affect the buyer's substantive rights. The burden of suit can be a barrier to legitimate grievances of the buyer, but where the seller carries his own credit, the effect produced by the means of payment touches only the practical extent of the buyer's remedies.

Today the combination of risks, the cost of credit information, and the cost of interest, book-keeping and collection make it impossible for many small sellers to carry their own credit. Where optional payment is offered to the customer, seller's credit is even more difficult to administer, since the prepayment feature requires sophistication and greater size to manage the fluctuations in cash flow. Forms of credit such as the bank credit card and overdraft chequing plans have appeared in addition to the more traditional forms of third-party credit. These kinds of credit seem to be less expensive to the small business than carrying their own credit, and have become quite successful.

The appearance of third parties complicates the effect of payment. The use of an agent to make even a cash payment affects the payor's substantive rights, although this situation is not involved in the payment system. But where a cheque or third-party credit is used, substantive legal rights within the payment system are affected.

Under section 165(3) of the *Bills of Exchange Act*, a collecting bank has the rights and powers of a holder in due course in collecting cheques deposited by customers for credit. Although collecting banks usually charge the account of a solvent customer when a cheque is stopped, they are under no legal obligation to do so. As holders in due course, their right to collect the cheque from the drawer is unaffected by disputes between the payee-seller and the drawer-buyer.

Although cheques factually involve the extension of credit during the collection period, they are not commercially thought of as credit instruments. A cheque is often taken with the expectation that it will be "as cash"—but that is almost always a commercial expectation. Legally, the condition that the cheque must be duly honoured on presentment controls. If so honoured, the cheque operates as payment at the time of its receipt by the payee. Until presented, it suspends the underlying obligation. The view that a cheque is taken as cash must be understood as subject to these qualifications and also as the product of a monetary system that required a deposit currency but was incapable of executing instantaneous deposit transfers.

The other negotiable credit instruments used by consumers are the subject of special legislation. This legislation requires such instruments to be marked, imposes criminal penalties for failure to mark them, and subjects the holder of an instrument so marked to all defenses and set-offs available against the seller.[180] The extent to which third-party transactions are covered is left to judicial development under a factual test: is the instrument issued "in respect of a consumer purchase"?[181] Two events are thus required to trigger the federal legislation: use of a negotiable instrument other than a cheque or its non-bank counterpart, and issue in respect of consumer purchase. Any draftsman who desires to evade the legislation need only render the instrument non-negotiable. Even when this easy escape route is not taken, the extent to which loan transactions are caught by the legislation is unclear. The difficulty is aggravated when the loan proceeds are not directly traceable to the seller.

Bank credit card plans evade the legislation because neither the voucher nor the cardholder agreement is negotiable. An overdraft chequing plan would not involve an instrument within the Act, nor would the credit extended necessarily trace unequivocally into consumer purchases. Any plan using electronic transfers would similarly evade the negotiable instrument requirement of the act.

It was recognized that federal legislation alone was incapable of dealing with third-party payment problems. Co-ordinate provincial action took place at the same time. But

the provincial legislation focused on a particular abuse—the assignment of contractual rights from a conditional seller to his financier, using a form contract in which the buyer renounced his defenses against the seller's assignees. The effect of this form is to give the financier the same power to override buyer's defenses that a holder in due course would have. The provincial provisions vary.[182] They are legislation of general application with respect to contracts, and as such will quite probably control in the absence of federal legislation expressly covering the effect of various means of payment on the buyer's defenses.

The provincial legislation generally covers seller's credit after assignment and lender credit where a connection between lender and seller can be shown through referral of the buyer or repeated transactions. There is no requirement of use of negotiable instruments to trigger its protection.[183] Loans are not covered unless security in goods purchased is taken.

In summary, existing federal and provincial legislation focuses on two events to trigger its partial outlawing of the cut-off effect: extension of credit to finance a consumer purchase and use of a negotiable instrument. Use of a negotiable instrument is a purely formal matter, and easily evaded. A variety of arrangements by which an extension of credit can be separated formally from a consumer purchase is apparent to any skilful draftsman. Even when a traditional cut-off clause is invalidated by the legislation, other clauses producing a similar effect may survive.[184]

To focus on the use of negotiable instruments is an obvious error, justified only as an ad hoc constitutional peg on which to hang policy. To focus on the use of credit, whether by instrument or otherwise, is a more subtle error.

The policy pursued by the statutes was to draw a line between cash and credit purchase, and to place all credit purchasers on the same footing, whether or not the seller carried his own credit. Purchasers by cheque were classed as cash purchasers. Cash purchasers never had the tactical advantage concerning burden of suit possessed by credit purchasers, while purchasers by cheque had such an advantage only until the cheque was paid.

The fact that the advantage was historically restricted to credit purchasers is no justification for its continued restriction. Until development of a deposit currency and the clearing network, it would have been impossible to extend the advantage of self-help to those who had made a cash payment. Today it is possible to extend such an advantage to those who have paid by cheque even after their cheques have been paid by the drawee.

A decision to extend this advantage would involve creating a procedure for charging back paid cheques to the depositor's account. In weighing the desirability of such a remedy it should be remembered that issue of a cheque in payment has never been viewed as affecting the buyer's remedies. The buyer has always been entitled to stop payment and defend a suit on the cheque. The buyer has always been entitled to use personal defenses—such as defective goods—against the payee.

The explanation for the exclusion of the cheque from the federal legislation discussed above is probably found in the absurdity of the marking provisions if applied to cheques and in the circumstances in which a cheque operates as cash. The only persons affected by the inclusion of cheques would have been collecting banks, which are legally covered by section 165(3) of the *Bills of Exchange Act* and which as a practical matter prefer their remedy against their depositor to an action against the drawer. Cheques, unlike the other instruments, had not been a conspicuous source of trouble. But consumer cheques were not normally coupled with a line of credit at the time of the legislation.

The present line of policy should be altered. As long as the seller's obligations were simple, a payment system that attempted to preserve the tactical advantages of cash sale for sellers was probably helpful in

solving disputes. Today the obligations of a person selling to consumers are detailed and increasing. Modern goods and services are complex. A cash sale model interferes with efficient resolution of disputes. Many transactions that have been superficially structured on the cash sale model because of the self-interest of institutional participants—bank credit cards, overdraft chequing and proposed debit cards with overdraft are examples—are actually supported by adequate credit information and are, as between the payor and his bank, a loan for the purpose of financing consumer purchases. There is no sound reason for treating these transactions differently from loans in respect of consumer sales.

But the defect in present policy is more serious than this. An enormous number of different payment transfer techniques can be made possible by use of a single plastic card. Even today's variety of banking package plans is only a foretaste of the future. If the decision whether rights to assert defenses or charge back transactions exist is based on the extension of credit with respect to particular sales, the draftsman of those plans will easily evade statutory control. Administrative control will be a regulatory nightmare. Consumer education and disclosure will be a forlorn dream. The variety of techniques available for inclusion in the package guarantee that the draftsman can produce a plan which only a lawyer can understand. Unfortunately, there will be pressure by interest groups in favour of such plans, which can plausibly be presented as being or requiring treatment as cash sales in which the bank is a mere lender, unassociated with the particular facts of any transaction.

What are the alternatives to the present policy? The more radical, but preferable, approach is to prescribe uniform remedies for consumers in all payments transactions, regardless of form. A slightly less radical approach is to exclude payment in authorized currency from the uniform remedial scheme. The traditional, but worst approach, is to make the sorts of consumer remedy available turn upon the technicalities of a particular technique, such as the existence of continuing or term credit.

The first approach is radical because it would abolish cash sale. Society is probably not ready for that yet, although cash sale is clearly an obsolescent way of doing business.

The second approach could be regressive, because it might encourage some businesses to revert to cash sale only. It would have the advantage of simplifying the data handling and consumer education problems of business and society. It could also greatly improve the justice and dispute-solving efficiency of the market place.[185] It would free deposit institutions from the creation of a totally misplaced regulatory effort.

The third, traditional, approach would simply be to extend existing ad hoc rules concerning finality and cut-off effect. The associated process of consumer education will be prodigious. In order to produce a comprehensible system, the regulatory apparatus would ultimately be forced to promulgate rules classifying plans and remedies as complex as those now found in the tax laws. Institutional compliance would be complicated and costly. But the worst criticism of the third approach is that it is wholly irrelevant to the actual problem. The problem is not allocation of remedies in consumer credit, but allocation of remedies in consumer payment transaction.

Recommendations on the proper approach to policy in this aspect must be contingent. If the study goals suggested for the cut-off effect and final payment aspects are adopted, the mix of services in a consumer account is essentially separate from payment questions. Accordingly, the study could omit such issues, and expect the market factor of consumer convenience to lead the deposit institutions to a proper mix.

However, if the present use of credit and negotiability to trigger wide substantive differences in law with respect to cut-off effect and final payment is continued, the study will be forced to consider techniques of regula-

tion and disclosure appropriate to produce informed consumer responses to the marketing of payment techniques. In view of the wide array of possible legal structures that must be regulated or disclosed, this sort of approach would entail vigorous government intervention in business activity. If possible, this approach should be avoided.

Further study would best be directed to the feasibility and required legal structures of a system that allowed freedom to business in developing new combinations of credit and payment transfers. But such a system is socially tolerable only if it provides for uniform consumer remedies and adequate control over problems of consumer credit. These problems have not been considered in this paper. However, analysis of legal and policy issues in the regulation of consumer credit would be enhanced by a realization that the problem of consumer defenses, although important, is a problem that must be dealt with in payment law generally.

The alternative to this approach is an attempt to classify, from the manifold forms available to the institutional draftsman, the forms of transaction that are truly consumer credit as opposed to those that are only accidentally so. Such an enquiry is both misdirected and unnecessary. Moreover, it guarantees a contest between institutional lawyers and legislative and regulatory draftsman that will effectively prohibit any chance of genuine reform in the law of consumer payments without increasing the efficiency of the deposit institutions. In the alternative approach, we are all losers.

Further study should consider how external payment is made as irrelevant in considering the remedies available to a consumer under contracts associated with the transfer of payments.

J. When Credited Externally

External credit refers to the time at which the payee receives credit for a transfer from his deposit institution. As a general rule, this occurs on the same day that the institution receives the transfer, whether it is a debit or a credit. Of course, if an instrument is taken on a collection basis, rather than as a deposit, this is not true.

As real-time processing techniques are introduced, a choice between same day and instantaneous credit becomes available. Real-time processing and exchange of transfers will alter the distribution of float. Real-time processing, with or without instantaneous credit, does not alter the initial allocation of the risks of collection. It may reduce the frequency of loss arising from insolvency of the drawer; it does not change its allocation. But in conjuction with time of settlement, the time of external credit affects the distribution of float within the system.

The other major effect of instantaneous credit is to alter the state of the customer's account. Up to now, it has been necessary as a practical matter to allow time for an institution to make the credit entries resulting from deposits. Thus, even a cash deposit is not instantly available for withdrawal.[186] Along with the legal effect of rights to charge back transfers, and the question of when debit transfers are finally paid, the time at which credit is made to the account will affect the position of such third-party claimants as garnishee creditors and a trustee in bankruptcy.

Further study must monitor the effect of developing practices of settlement and external credit to assure that equitable allocations of float are made. Further study must also develop an analysis of the effect on third-party claimants of transactions where the depositor receives credit. This analysis should be legally and commercially consistent with the analysis of when debits are paid, and with the effect of rights to charge back transactions through the system.

K. Finality of Payment

Finality of payment has both legal and practical features. In dealing with finality, the law today creates a distinction between paid and unpaid negotiable instruments. The legal doctrine of finality concerns legal remedies on paid instruments. Payment also has practical consequences, even when legal remedies exist. Finality is therefore involved in deciding whether the right to charge back a

debit transfer should be enlarged. That right is presently a remedy of the deposit institutions that requires no recourse to the courts. It is part of both the cheque clearing and the bank credit card systems. In both systems it protects the drawee institution.

In the chequing system, final payment terminates the right of the drawee to make any claim for recredit based on forgery of the drawer's signature.[187] Under the merchant agreement in the bank credit card system, the right to charge back for forgery is not restricted to unpaid instruments. Payment is not really in issue, since credit card transactions are entered against a line of credit in the cardholder's favour. The equivalent to application of the principle of final payment would be termination of the right to charge back a transaction based on the issuer's entering the transaction against the line of credit. But the right to charge back does not appear to be so limited.

The final payment doctrine may be justified on various gounds. It once may have been based on the duty of the payor (generally a bank) to know the drawer's or acceptor's signature (its customer). But that rationale failed when the rule was extended (in England, but not in North America) to forged endorsements. The rule is defended on principle as a just refusal to shift loss between two paries, both of whom are wholly innocent. But the most persuasive justification is that it would be an intolerable inconvenience in commercial life if those through whose hands a negotiable instrument had passed were unable to rely on their right to notice of dishonour. If the doctrine were abrogated, then the time requirements as to notice of dishonour would have to be dispensed with—otherwise the unfortunate person who received payment would lose his rights to recover against all secondary parties. The first alternative is commercially intolerable; the second unjust, since there is usually reliance on the liability of the immediate transferor.

With respect to consumer payments, none of the justifications is persuasive. Negligent examination of the drawer's signature has never been a sound justification, since the doctrine applies regardless of the forger's skill or the bank clerk's competence. Most consumer payments are in amounts for which the examination has become an empty formality. For electronic forms of transfer, examination of signatures is impossible.

The justification from principle is superficially persuasive. Refusal to shift loss between innocent parties can be defended as an economical use of the judicial system. But in practice the principle imposes on paying banks losses over which they have no practical means of control. The person with practical control over the quality of a forger's identification is his victim. Quite commonly, the victim is the payee. But the doctrine of final payment prevents shifting these losses to the payee in an economical manner.

The justification based on commercial inconvenience is as persuasive today as when it was developed. But it is based on a pattern of reliance that is more persuasive when endorsement is involved. Consumer payments are deposited for collection, not negotiated. Reliance on endorsement is not sufficiently common to influence policy. The only endorsement that usually takes place is from payee to collecting bank. That endorsement is unnecessary, since the collecting bank has statutory rights against the drawer and a contractual relationship with the payee.

The relationship between the deposit institution system and the payee is a continuing one. The reliance is not on a single instrument, but on the account relationship and the constant flow of transactions. In such a relationship, some uncertainty can be tolerated. Abolition of the doctrine of final payment for consumer cheques, or a general extension of rights to charge back transactions, is possible within a continuing account relationship as long as the ratio of items charged back to items paid or carried to account without a chargeback is sufficiently low.

A second feature of finality of payment arises from the economics of the legal system for adjustment of losses. Minor grievances will not support the cost of suit. The

only practical remedy is an out-of-court remedy. A power to withhold payment or a right to reclaim it without legal process shifts the burden of suit. Remedial consequences fully as important in their effect on the consumer as the unenforceability of cut-off clauses would follow from such a right.

The right to charge back an item from the paying institution to the payee exists for unpaid debit instruments and for bank credit card vouchers. Exercise of the right is restricted to credit card issuers and paying deposit institutions. The consumer has no right to make chargebacks and thus has no simple out-of-court remedy against the payee.

It should not be assumed that such restrictions are foreordained. Clearing systems can provide for the automatic collection of judgments from member accounts in certain circumstances.[188] The consumer's bank in a bank card plan has very broad chargeback rights that are not ended by payment of the voucher or dependent on legal proceedings. Automated clearing proposals in California and Atlanta have introduced a consumer chargeback right.[189]

Broad rights to charge back transactions could be created for consumers. Consumer use of a chargeback right would be directly related to the incidence of consumer complaints over sales and services. Many merchants already follow policies in relation to such complaints that could not be successfully carried out if the incidence of complaint was not predictable.

If a merchant carries a substantial proportion of his own credit, the effect of a chargeback right on his operations would be indistinguishable from the effect of a decision to follow a consumer-oriented policy for adjustments and returns. In either case, some portion of his sales and accounts receivable is contingent. The change in the payment system would probably not even affect his internal procedures, since use of the chargeback remedy should be conditioned on failure of efforts to adjust the dispute in good faith directly with the merchant.

Where merchants are not carrying their own credit, and still follow a consumer-oriented policy on adjustment and returns, the result is similar. Such merchants have formally or informally created a reserve of working capital to cover transactions that would potentially be charged back. Again, since an effort to adjust the dispute in good faith should be a condition precedent to the consumers right to charge back, it is unlikely that these merchants need change any of their practices.

Such a chargeback right would also correspond with the contractual rights reserved by banks against merchants under bank credit card plans.

A consumer chargeback right would affect the merchant who uses no credit card plan, extends no credit himself and deals on a cash or cheques only basis and a no-returns policy. If he is selling poor quality goods or services and escaping the results because of the high cost of suit, that merchant will probably be forced out of business. If he is selling honest goods, he will only need to create an additional reserve of working capital to cover occasional chargebacks.

A consumer chargeback right would affect possessory rights of some sellers and persons who provide services in two situations: one analogous to obtaining goods by issue of a cheque for insufficient funds; the other to recovering goods subject to a chattel lien, particularly automobiles from garagemen.[190] The latter situation would be particularly serious in provinces in which such liens are wholly possessory. However, several provinces have found it possible to protect the lien by allowing its registration.

At common law, an unpaid seller who has delivered possession to the buyer is in an unenviable position. Unlike a conditional seller he has no right to repossess. Although a fraudulent buyer may be ill-situated to contest repossession, the goods are unlikely to be available for repossession once in the fraudulent buyer's hands. And once resold to a purchaser in good faith, they are gone beyond recall.

The persons who recover goods subject to a chattel lien are not as likely to be immoral as fraudulent buyers. They usually have a misguided view of their legal position as owners, and believe the lienor to be morally and legally wrong in withholding possession from them. In such a case, the goods may be available for repossession under a registered lien.

A right of consumer chargeback could be abused in a number of ways. First, goods could be obtained for immediate consumption or services could be obtained that did not enhance the value of some sort of property. If the price was charged back in such cases, there would be nothing of value to repossess or against which to assert a lien. Even where services were rendered which did enhance the value of property, they might not increase the value of that property, over other prior security interests to the extent that a lien right had any money value. However, the right to repossess has a practical value in encouraging payment, so that the possible abuse feared here is probably restricted to goods that are consumed immediately. In this situation, fraud is a possible, but not a necessary, element of the abuse.

Second, goods of more enduring value could be obtained with fraudulent intent to charge back the price and conceal, abscond with, or resell the goods. They can be so obtained today by making a cheque drawn on insufficient funds or a non-existent account. From a societal point of view, the probable resale is no harsher on the innocent merchant than the case of an innocent purchaser buying stolen goods from a thief. In both cases, innocent parties suffer. The question is not whether such transactions are possible, but whether they are less probable under one system than another.

Today, a request for cheque verification, which is rarely made, can detect cheques drawn on non-existent accounts and some cheques drawn on insufficient funds. Such a request will not detect all cheques on insufficient funds. Nor can it detect a fraud by impersonation and forgery or by withdrawal the balance of the account between issue of cheques and their presentment.

Under a consumer chargeback system, use of the remedy could be conditioned on an effort to settle with the merchant in good faith and a formal demand to the consumer's deposit institution. Such a system based on an identifiying card could be structured to provide a far better chance of identifying those who commit fraud than exists under the present chequing system.

Third, problems could be experienced with crank purchasers. These people commit no wrong so long as they pay or return the goods. If their numbers or persistence constitute a burden on the system, they can be denied either banking accommodation or the use of the chargeback remedy. The former would appear to be a commercial decision; the latter would require at least some sort of administrative proceeding, since it would deprive the sanctioned party of a civil right.

These three sorts of abuse do not seem a clear cut justification for rejecting a right to a consumer chargeback. The risks of fraud involved in structuring a right to a consumer chargeback are not as great as might be initially thought, and must be balanced against probable benefits.

Another obvious objection to the consumer chargeback is its inflexibility. In many situations, such as grossly defective goods or erroneous entries, a chargeback reversing the initial entry is the proper solution. But for minor defects, the law of sales gives an unliquidated remedy in damages. The chargeback remedy is incapable of the nice distinctions between conditions and warranties and their relation to the buyer's right to reject goods in the existing common law of sales.

Two responses can be made. First, no self-help remedy can take account of the distinction between breaches of conditions and warranties in the common law of sales, and the resulting rights to the price or to an unliquidated sum in damages. So the objection is not to chargebacks for breach of warranty, but to chargebacks in themselves. An

honest consumer negotiating in a clear breach of warranty situation will probably settle for repaired or substituted goods or an abatement of the price, without ever using the chargeback. The actual incidence of chargebacks over minor grievances need not necessarily be great.

Second, the chargeback does nothing more than shift the burden of suit. Where a credit sale is involved, it does not even do this. The burden is shifted from legally unsophisticated parties to parties who are capable of organizing their litigation on an efficient and relatively uniform basis. The merchant's lawyer can achieve economies of scale unavailable to the consumer's lawyer.

Other advantages to the consumer could be made available by the provinces as consequences of a shift in the burden of suit. A consumer chargeback right in payment transfers might be happily combined with the sort of administrative dispute-resolution apparatus proposed by the Ontario Law Reform Commission.[191] Under such a system, sellers and others responsible for comsumer complaints would be required to enforce their claims in a publicly scrutinized forum. Not the least benefit of such a system would be the automatic production of comprehensive and statistically accurate records of all unsatisfied consumer grievances as a by-product to the dispute resolution process. Such records would be an enormous aid in rendering visible the darker reaches of the market place. The very existence of such system would substantially reduce the opportunities for fraud by providing a speedy remedy and would help to drive sellers of over-priced shoddy goods out of business.

The chargeback system itself could be a major aid in policing the market. It is unlikely that deposit institutions would view an abnormally high number of chargebacks to a merchant's account with favour, since such chargebacks would quite probably adversely affect the security of the merchant's banker by decreasing his rights of set-off. It is also unlikely that an abnormally high level of chargebacks by a consumer would be tolerated by a deposit institution.

The sanction in both cases would likely be withdrawal of the banker-customer relationship. That relationship is a commercial necessity to merchants and a great convenience to consumers. A little moral suasion by branch managers based on their own interest in holding chargebacks down might therefore be effective in making a right to a consumer chargeback an effective device for policing the market.

Would the consumer chargeback become an engine for consumer frauds? Only experience can provide an answer. For small items, there would be considerable time associated with operating a fraudulent scheme. For larger items, it might be necessary to view a chargeback as a tender of rescission giving the seller an immediate right to elect between repossession and damages or an action for the price.

In fact, the chequing system is probably as prone to abuse as a consumer chargeback system would be. It affords the same basic opportunity for fraud—"payment" by a worthless cheque to obtain possession of goods or provision of services. Against the possibility of consumer fraud must be weighed the certainty that most people are honest. Against that possibility must also be weighed the certainty that the present system actively promotes the sale of shoddy goods and petty fraud by unscrupulous merchants through its failure to provide either an easy consumer remedy or a self-operating administrative audit of unsatisfied consumer grievances that produces statistically representative information.

The chargeback for the consumer is a new solution to the practical effects of finality. The legal effect of finality raises other issues. The legal effect is to place the risk of some unauthorized transactions on the paying bank and its customer, which under other rules would fall on the depositor.

The depositor already bears the risk of the unpaid unauthorized instrument. It seems unlikely that security procedures of depositors would be changed by adopting a chargeback for paid instruments. Justification for such a

chargeback would appear to rest on a showing that it would simplify the routine processing of transactions—perhaps by totally eliminating paper examination by the drawee—and thus produce an improvement in the total cost of payment services without unacceptable side effects.

The practical effect of finality is to decrease the adequacy of dispute-resolution techniques in the consumer market place. Although the control over payment techniques is primarily federal, the creation of a consumer chargeback would require consequential changes in the law of sales and consumer protection to be fully effective. These changes could be implemented by contract in some cases.

Further study should invite and carefully consider representations from the deposit institutions on whether abandonment of the final payment doctrine in consumer payment transactions would simplify their operations. The study should carefully explore the legal structure required to make a right to a consumer chargeback a workable part of the payment system. Such exploration should include necessary protection for the unpaid seller, the rights of chattel lien-holders and their protection, and the sort of administrative apparatus that might usefully be combined with the consequent shift of the burden of suit to produce socially efficient collection of consumer debt. These issues could best be explored in cooperation with one or more of the provincial law reform commissions.

L. Cut-off Effect

A cut-off clause is one that strips a party to a contract of defenses arising from the contract against subsequent assignees. Negotiable instruments, when in the hands of a holder in due course, have a similar property with respect to most common defenses to a seller's action for the unpaid price—since the instrument was given in payment of the price, it "cuts off" these defenses. A third variety of clause—the non-dispute clause—requires a party to litigate all claims with the other original party, rather than with subsequent assignees. These clauses can be used to produce the "cut-off effect", which is that rights against the original party—usually a seller—cannot be enforced or used as defenses against the financier of the transaction.

It is true that most cheques are never negotiated. However, the status of holder in due course conferred on collecting banks by section 165(3) of the *Bills of Exchange Act* brings most cheques legally within the class of instruments having a cut-off effect.[192]

By virtue of a non-dispute clause in the cardholder agreement, payment by bank credit card also has a cut-off effect. Since the issuer does not occupy the position of a connected lender under section 189 of the *Bills of Exchange Act* and since the usual provincial legislation against cut-off clauses is directed at an assignment of a conditional sale contract, or at most at chattel security financing without regard to form, bank credit card plans wriggle through unscathed by legislation against the cut-off effect.[193] This is so even though the banks have very broad rights against participating merchants.

The two-faced nature of the plans is not only legal, but commercial. The merchant is sold the plan as a substitute for carrying his own credit, but the consumer is induced to use it as a substitute for cash.

The deception in inducing the consumer to perceive a bank credit card as a cash substitute is very clear. The consumer comes to associate his remedies on transactions involving such card with those appropriate to a cash sale. The issuer banks thereby foster a climate of opinion in which disputes with cardholders will be less frequent. But the merchant-bank agreement contains broader chargeback rights in favour of the bank than those for cheques. The issuer banks take only the credit risk; on other sources of risk they have carefully preserved their recourse against the seller. They have not given final cash payment to the merchant for the transaction. Attempts to cause the consumer to perceive use of the card as equivalent to the use of cash are deceptive. Given the chargeback rights against the merchant, enforcement of the non-dispute clause is uncons-

cionable for the same reasons that led to the legislation against traditional cut-off clauses.

The reaction of consumers to revolving credit plans—of which the bank cards are the most broadly used—is mixed. Some appear to treat the plan as high-cost medium term credit; others as a convenience credit (often at very high cost); still others obtain a free ride—passing all their cost of borrowing on to the merchant and the other customers of the issuer.

Original hostility to the "cut-off effect", which was vented both legislatively and judicially in the last decade,[194] was focused on medium term credit. Shady dealing by the seller often figured prominently in the reports. The time has come to recognize a new rationale for these cases. The increasing complexity of modern consumer durables and the alienation of the production line employee have led to a high and apparently unpreventable incidence of latently defective consumer durables. At the same time, the commercial structure used to produce and distribute many goods has become so concentrated since the *Sale of Goods Act* that the freedom of contract which is that Act's principal goal has become an altar on which the consumer is offered as legal sacrifice. The response has been both piecemeal reform[195] and proposal for a more modern approach to the whole area of substantive consumer rights.[196]

It has already been suggested that not only the substantive rights of the consumer, but also his remedies—and particularly his self-help remedies—are in major need of review. The "cash sale" model which underlies cash, cheque, and bank card payment today is outdated. It assumes that a seller's obligations are simple and limited, and that placing the onus of suit on the buyer will therefore promote a dispute-free market.

In fact, the seller's obligations are, and must be, complex in today's market. The result is that in a sale of new goods to a consumer from commercial distribution channels, the consumer is placed largely at the seller's mercy.

The potential choices for payment offered by our society are also extremely complex. The cash purchaser and the vendor who carries his own credit are today accompanied by conditional sales finance and loan outlets with widely varying degrees of connection to the merchant.

Obtaining goods and services on credit is a social fact. The legal forms by which it is achieved, concealed, and structured to evade regulation are remarkably complex. This complexity should not affect the substantive rights of consumers against suppliers of goods and consumer services.

The possible improvements a consumer chargeback could produce in the market place have already been mentioned. But if those results are contingent on the seller being the financier in all cases where credit is used, they will never be realized. Moreover, the system will be difficult to implement because of the requirement of sorting out transactions to which the remedy applies. Even if applicability is determined by the sort of transfer technique used, barriers to choosing the most reasonable technique from technical and commercial points of view will be created.

These problems are created because the legislation against the cut-off effect with which we are familiar was based on negotiability and on secured consumer sales financing. It focussed on forbidding the cut-off effect where it was achieved through a negotiable consumer note or assignment of a consumer's conditional sale contract. The connected lender doctrine could be invoked to deal with obvious evasions, and some provinces expanded that doctrine legislatively.

At the time of its adoption, legislation against the cut-off effect covered the significant forms of consumer sales credit in which the ultimate financier was not a party to the contract of sale. However, it did not reach the definitional problems in sales credit posed by the bank credit card and the financing overdraft.

The relevant tests for involving a financier in a consumer sale are commercial foreseeability or actual knowledge. If the financier knows because of a loan application he has accepted that he is financing a consumer transaction, he should be subject to the purchaser's defenses. If the financier knows because of the nature of the commercial paper he purchases that he is financing a consumer transaction, he should be subject to the purchaser's defenses. If the financier is purchasing or otherwise obtaining a substantial proportion of a merchant's accounts receivable or his commercial paper and that paper or the accounts result from consumer transactions, the financier is party to a plan that has as a commercial goal or commercially foreseeable consequence the provision of consumer finance. He should be subject to consumer defences.

The principal extensions of the legislation against the cut-off effect resulting from the above view would be to the bank credit card and to the financing overdraft on a current consumer account. These two forms of consumer credit do not have the tidy one-to-one correlation with consumer sales and services transactions of the more traditional forms of credit. But they are of great potential importance, and to an important and increasing extent occupy the medium price market for consumer goods and services with more traditional forms of credit. In the case of the bank credit card, merchant participation is sold as an alternative to merchant credit plans.

Not all loans to consumers would fall within the above prohibition of the cut-off effect. A lender should be able to claim the benefit of the cut-off effect if the funds borrowed are unrestricted as to use, the lender is unaware of their intended use in a consumer sale, and the transaction is not a pre-authorized advance. If the lender is approached by the consumer independently under these conditions, the lender cannot foresee the ultimate use of the funds.

The cut-off effect should be eliminated in consumer transactions without regard to amount. Although some have argued that petty transactions should be exempt, there should be no dollar exemption. Such an exemption is likely to be a middle-class estimate of how much damage the poor can afford to suffer without "real" injury. But besides its built-in regressive effect and probable bias, it is an invitation to chicanery.[197] The true control on petty claims is that for a genuinely petty transaction the nuisance involved in making even a simple out-of-court claim is not worth the recovery.

There may be consumer transactions—one pictures the purchase of a meal in a restaurant—in which any dispute as to the quality of goods or service rendered should take place before payment or not at all. If such is the case, a legal system responsive to social needs would provide a separate rule for such transactions. That rule, however, has nothing to do with cut-off effect. It is a special rule as to finality of payment.

Rules about cut-off effect have become confused with rules about finality because the credit system has used them to destroy defenses on unpaid instruments. If the underlying transaction is used to justify what is claimed to be a need for rules about cut-off effect it must be finality of payment that is in question. Rules about cut-off effect have always been based on the necessity of freeing the payment from all of the incidents of the underlying transaction.

Further study should explore the extent to which it would be feasible to eliminate the cut-off effect in consumer transactions. The study must recognize the ease with which formal privity can be evaded, and focus on defining a boundary between the true loan and loans in which the lender is associated in the servicer's or seller's efforts to promote use of the funds loaned. Traditional views of who is a connected lender are inadequate to cope with modernized forms of payment used in association with consumer credit. The promotion of mass credit schemes such as bank credit cards has focused on replacing seller's credit. From the merchant's point of view, the bank cards are said to be a cheaper means of making credit sales than carrying your own accounts. But to the

extent that either bank credit cards use or overdraft chequing replaces seller's credit under the present rules, the consumer loses rights. The rights in question were only recently secured to the consumer; it is important that changes in the forms of consumer credit should not circumvent them.

SUMMARY

This study reaches conclusions about the point of view from which analysis of payment law should be carried out, about control of the payment system's arrangements for exchanges of tranfers—the clearings and related exchanges—and regulation of the competition between, and powers of, deposit institutions, about the sorts of transfers which the law should be organized around, and about the issues involved in forming legal policy for the payment system—the issues deserving of further legal study, and the technical issues whose results may affect legal policy.

Conclusions Affecting Analysis

The existing law establishing functional rules for payments is technologically obsolete. It can no longer provide a meaningful structure for the exchange of funds. Its basic constructs are not effective models of modern payments transactions. Unless those constructs are redefined, the law must become needlessly complicated in coping with new developments.

The goal of fundamental fairness is a necessary and historic role of commercial law in structuring transactions. But this goal can only be achieved through intelligent compromises between technical capabilities, commercial freedom and efficiency, and consumer protection against the consequences of ignorance and excessive institutional bargaining power. Existing law governing use of exculpatory clauses by deposit institutions and customer consent to the release of confidential information ignores the consumer's lack of understanding and inability to bargain when confronted with a contract of adhesion prepared by a deposit institution.

The existing law contains numerous technical barriers to efficient exploitation of electronic payment technology. Use of these barriers by consumers or institutions to avoid change is socially costly. Barriers to full use of electronic technology that cannot be justified by social policy should be removed.

In preparing a new structural system, it is not enough to remove technical barriers. Unless their removal is combined with a re-conceptualization of the system, the new structure will never realize its potential for simplicity or adaptation to further change. A *Cheques Act*, an *Electronic Transfers Act* or minor revisions to the *Bills of Exchange Act* would remove only the technical barriers to change.

The structural role of payments legislation in a rapidly changing technical environment and the diversity of Canadian society requires avoiding legal requirements that demand the use of particular forms. Legislation must structure risk, not technology. The temptation to pursue constitutionally simple solutions at the expense of socially sound ones must be avoided. The payment system must be approached and structured as a system.

Conclusions Affecting Control of System, Competition, and Powers of Deposit Institution

The primary institutional change recommended is the designation of a new regulator for the clearing system. Access to all forms of payment transfer techniques must be available on non-discriminatory terms to all deposit institutions. Equitable terms for such access must reward innovation without foreclosing competition. This principle may require extending regulatory powers over clearings to the exchanges of other payment information between deposit institutions. Changes in the form of payment information exchanged do not eliminate the public interest in the payment system.

For the purposes of promoting greater knowledge of the payment system and providing a broadly based contribution to the regulatory process, a policy advisory committee, drawn from the end-users of payment techniques, should be created to aid the

regulatory process. This committee should report publicly on a periodic basis to the Governor of the Bank of Canada and the Minister of Finance. This somewhat unusual joint report is suggested because the range of the committee's concerns seems likely to reach matters within the responsibility of both the Bank and the Department of Finance.

During the transition period to a new payment system, such a committee could serve a useful role by providing a sounding board for proposed changes. It could thus fulfill an educational role as well as aiding in policy examination.

Numerous minor institutional changes will probably be required by the growth of new payment techniques. Definition of the roles of deposit institutions, communications carriers, and the computer industry will require continued monitoring of needs for change in the powers of deposit institutions, and of competitive policy in the financial sector.

Coordinated development of competition policy in the financial sector is now hindered by the differences in regulatory standards under proposed amendments to the *Combines Investigation Act* and the *Bank Act*. The rules established in proposed section 138 of the *Bank Act*, if valid, are applicable to competition between deposit institutions, as well as banks. It should also be noted that compliance with clearing rules approved by a government regulator would fall within the "regulated industry" exception to combines offences. Uniform norms for deposit institutions in combines matters would provide uniform standards even where varying inspection and enforcement was preserved for administrative efficiency. Recasting the proposed section 138 in terms applicable to all deposit institutions would appear to be compatible with the concerns of various financial groups that they not be subjected to hordes of inspectors exercising piecemeal authority over their operations. Uniform standards expressing competition policy for payment services would be an important spur to competition among deposit institutions.

Conclusions Affecting the Basic Organization of Payment Law

The substantive goals to be pursued by a study of payment techniques would be the creation of two new transfer concepts and a set of standards for their institutional handling. These concepts would be a consumer transfer and a commercial transfer. Over the longer term, useful work might be done on a standardized consumer credit instrument and a negotiable commercial instrument suitable for documentary transactions.

Neither the consumer transfer nor the commercial transfer would possess all the legal characteristics of negotiability. Most of those characteristics are fossil remains of a monetary system based on bank notes and widespread discounting of commercial bills of exchange. Instead, such issues as transferability, risk of unauthorized use and relation to the underlying transaction would be explicitly settled. The role of contracts of adhesion in structuring consumer payments would be recognized. Such contracts would be subjected to legislative and judicial control.

Handling standards would ensure that the allocation of risk created for the transfers outside the deposit institution system was preserved. They would define the basic responsibilities of the participants in the system and settle questions of priorities now thought of as questions of the state of the account.

Successful resolution of the issues raised by consumer and commercial transfers would largely resolve the structure of the future payment system. Various governmental instruments and transfers would require provisions to bring them appropriately within the structure. Provision for anomalous techniques such as the traveller's cheque and the personal money order might be useful in order to guide the courts in the inevitable process of analogizing such transfers to a new conceptual structure. But legal rules structuring consumer and commercial transfers and their handling practices would supply a more comprehensive and practical structure than exists today.

Conclusions Affecting the Formation of Policy: Requirements for Monitoring and for Further Legal Study

The flexibility of present transfers in terms of the person to whom they are payable will be greatly decreased because of the necessity to standardize transactions in moving to electronic transfers. This necessity allows specialized allocations of risk to protect consumers.

The single authorization system for pre-arranged transactions is convenient to banks and major users of the payment system, but reduces the consumer's control over his account. Adequate safeguards need to be developed; inquiry into their nature should consider problems of consequential dishonour and the desirability of an automatic remedy for consumers complaining of unauthorized or erroneous transactions.

The extent to which a single plastic card presents a variety of services to the consumer is a question that ought to be left to the business judgment of deposit institutions, subject to non-discriminatory treatment for non-banks in access to payment exchanges and to the acceptance of the study recommendations on finality of payment and cut-off effect.

Truly negotiable electronic transfers may someday be useful in the money market or in specialized commercial applications, but the specialized groups who would be involved with such transfers are better able to protect themselves than consumers and business generally. Legal study of the structure of such transfers can be deferred; the former topic should be considered as part of the effect of computers on the capital market.

Access to the payment system will also become more specialized as electronic transfers are introduced. The necessity for standardized data poses problems for competition policy concerning the ability of users to obtain desired services and to bargain for risk allocation. Additional problems arise from the most economic use of remote terminal facilities, whether they be point-of-sale terminals owned or controlled by a deposit institution or remote teller devices.

At the point-of-sale, the conflict between retailer and deposit institution interests over the capabilities and standards of electronic equipment requires continued monitoring. The expectations induced by display of a deposit institution trade-name or symbol at the point of sale must also be considered from a legal point of view. If the study recommendations concerning finality and cut-off effect are not accepted, the use of disclosure at the point of sale to inform the consumer of the consequences of certain payment techniques should be considered.

As home and office terminals become more available through the increased capacity of local communication networks, services offered through these terminals will require continued monitoring. Such monitoring should consider the extent to which these services are compatible with the other business of deposit institutions, and with efficient satisfaction of social demands.

The results of this monitoring should be used to review and re-define statutory restrictions on the business of deposit institutions, insofar as reforms lie within federal jurisdiction. They should also be used to assure that competition policy is not frustrated through parallel decisions about whether terms or on what certain markets will be served. In situations where shared use or organization as a utility is most efficient, government has a duty to ensure that efficiency is not a cloak for discriminatory practice or non-competitive behaviour. In those areas where monitoring discloses an absence of competition for business or a refusal to bargain, governmental study should independently verify the fairness of the terms imposed and the reasonableness of the decision to refuse to serve the market.

The scope of networks for the exchange of payment data is today quite diverse. In this area, governmental policy formulation is more advanced than in many others discussed in this paper. That policy formulation is aimed at creating a basic communications

network. A distinction may be drawn between the creation of a basic communications network and the right to transmit particular kinds of traffic over that network. It is implicit in a policy of non-discriminatory access for non-bank institutions to a payments network that they be granted not only a right to connect to the network, but also a right to participate in significant exchanges of payment data. The institutional recommendation that non-banks should have a voice in the control of the clearings and other payment exchanges that may develop has a corollary here. Non-banks must be allowed rights to initiate and receive on a non-discriminatory basis payment transfers of all kinds within their legally authorized business.

The possible options for control of the network are varied. Again, a distinction between the basic communications network and special kinds of message traffic moving in the network must be recognized. Non-discriminatory treatment implies access to the basic network for all institutions; it additionally implies a voice in decisions concerning major kinds of transfers, although those decisions may be taken by user groups and not by the organization controlling the basic network. In this context, deposit institutions may be user groups.

The decision on control of the basic network will establish the framework for subsequent action. That decision will require legal implementation. But more than statutory changes to structure regulation of the basic network is involved.

The policy of non-discriminatory access to the payment system for deposit institutions will require continued monitoring of new payments developments for evidence of abuse of control. This monitoring is an aspect of competition policy regarding the financial sector. Further study must maintain liaison with groups implementing policy concerning both control of the basic network and competition by user groups through particular exchanges. The standards now governing competition among deposit institution are split between the proposed *Bank Act* and *Combines Investigation Act* amendments. Although responsibility for enforcement and inspection need not necessarily be unified, it would be desirable to create a single standard to govern user group competition in the financial sector. The issues involved in network control and regulation are complex enough. A legal structure that generates spurious issues should not be created.

The process of settlement between deposit institutions is a complex one. Changes in the time or manner in which settlement is made affect the total costs of transfering deposits. Continued monitoring of the development of settlement techniques must therefore occur to carry through the policy of non-discriminatory access to the clearing system—a policy that should be extended to all major exchanges of payments data.

Further study of settlement practices should be directed towards isolating consequences for payees and collecting institutions of new developments and of making cheques and non-bank orders legally identical.

The mode of processing payment transfers has a very important effect on the sorts of knowledge that institutions have when they pay transfers. The mode of processing should therefore affect the risks to be borne by deposit institutions. Decisions on the proper risks to be borne may allow great simplification in the processing and documentation of payment.

Further study here should consider the proper allocation of risk and the desirability of eliminating any formal or probative use of paper for transfer purposes. Such study would necessarily involve reconsideration of the evidentiary and criminal aspects of payment techniques—of proof of payment and of forgery.

The direction of data flow, in an unreformed legal system, could have a serious effect on choice of the proper legal analysis for a problem. Since direction of data flow is dictated by technical and cost factors, rather than by social demand or policy, it should be made legally irrelevant.

Further study should be directed to structuring legal rules developed so that the direction of data flow is irrelevant to the end users of the payment system. Participants in the system will still be concerned with direction of data flow—but their concern should be for commercial convenience, rather than legal effect.

The choice of payment terms between the payor and his deposit institution today affects the legal and practical distribution of remedies between the payor and the payee. Payment terms can be manipulated to frustrate settled policy in the consumer area.

Further study should preferably bypass all questions of the proper relationship between debtor and creditor, and focus on allocation of risk in payment transactions. The means of external payment should be irrelevant in determining consumer remedies. This can only be done by extending principles now thought of as concerning sales credit into all uses of deposits for payment. This is a major change. But the alternative is to regulate the detailed provisions of the payor—deposit institution contract. The alternative would require regulatory authorities to take a major role in the design of new payment techniques and combinations of such techniques.

The time of external credit has two major effects. First, along with other factors such as settlement procedures and times and the time at which transfers are charged to account, it affects the incidence of float. Thus it affects the cost of carrying on a transferable deposit business. Second, along with the problem of when transfers are finally paid, it affects the state of the account. Problems of the state of the account are primarily contests between creditors, and the question of credit or payment is a spurious substitute for a decision over which claimant should have priority.

Further study should monitor the effects of evolving settlement and external credit practices to assure that float is allocated equitably. Such study should develop an analysis of the priorities of account claimants that is legally and commercially consistent with the problem of when debits are paid and the existence and extent of chargeback rights.

Final payment has both legal and practical aspects. The legal doctrine today seems obsolescent in the light of how deposit institutions actually do business—particularly in the consumer area. The practical effect of final payment is to decrease the efficiency of market forces in protecting consumer interests.

Further study should explore how deposit institution operations and efficiency would be affected by abolition of final payment. Such study should develop the legal structure for a consumer chargeback, including necessary consequential changes to protect sellers and lien-holders. The study might profitably be coordinated with provincial law reform activity in sales law.

Legal devices for stripping purchasers of defenses have a useful role in transactions between knowledgeable parties with equal bargaining power. They serve no useful purpose in consumer markets, where neither equal knowledge nor equal power are customarily present. Such devices have already been partially ousted from the consumer marketplace.

Further study should consider the total elimination of the cut-off effect from consumer transactions. Such study must recognize that mere prohibitions of assignment are insufficient, and must render the so-called independent lender a party to any transaction in which he is involved by knowledge or promotion of his own business interests.

The payment system affects the lives of every consumer in Canada. Its smooth operation is vital to the business community. Its effect on the consumer marketplace is not commonly understood, and could be greatly improved. But the developments now taking place must be appreciated as offering much more to society than cost-savings to the deposit institutions.

The deposit institutions have the technical ability to install a payment system that offers consumers not only a faster, but also a more

secure and more equitable way of making payment. The extent to which such changes will occur depends largely on citizen and governmental response to the possibilities opened by the new technology.

FOOTNOTES

The following standard sources receive abbreviated citation by the name of the author or in the manner indicated throughout these footnotes.

Chalmers, *Bills of Exchange* (13th ed. 1964);

Falconbridge, *Banking and Bills of Exchange* (7th ed. 1969);

J. A. Galbraith, *Canadian Banking* (1970);

E. P. Neufeld, *Financial System of Canada* (1972);

Paget, *Law of Banking* (7th ed. 1966);

Report of the Royal Commission on Banking and Finance (1964) (hereinafter Porter Commission);

American Law Institute and National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code* (1962) (hereinafter UCC).

1. *Bank of Canada Act*, R.S.C. 1970 c. B-2, S. 21. The issue of demand notes intended for circulation was once the hallmark of a bank. See Hearings, House of Commons Standing Committee on Finance, Trade and Economic Affairs (1st sess; 27th Parl.) 2012 (1966) (testimony of E.P. Neufeld). The existing note issue is a monopoly of the Bank of Canada. Bank Act R.S.C. 1970 c. B-1, s. 75(2)(a).

2. *Currency and Exchange Act*, R.S.C. 1970 c. 39, s. 4-5, 8.

3. *Id.* s. 7.

4. *Bank Act*, R.S.C. 1970 c. B-1, s. 157.

5. See generally McDonald, *The BNA Act and the Near Banks: A Case Study in Federalism*, (1972) 10 Alta. L. Rev. 155; Baum, *The Near Banks: Trust Companies of Canada*, (1971) 45 Tulane L. Rev. 546; and Porter Commission 155-200.

6. See generally Porter Commission, 201-266.

7. See Porter Commission, 377-378.

8. While the power to honour third-party orders is useful, it not absolutely essential—particularly if remote withdrawal facilities exist. Canadian institutions which presently participate in payments have explicit or assumed power to honour third-party transfers.

9. R.S.C. 1970, c. B-1. Strictly speaking, "bank" includes various federal agencies that conduct no deposit business with the general public and the Montreal City and District Savings Bank. The latter has corporate powers quite different from a chartered bank, and is legally restricted to the province of Quebec. See *Quebec Savings Banks Act*, R.S.C. 1970, c. B-4. It is a member of the Montreal clearing in its own right. *Rules and Regulations Respecting Clearing Houses*, Rule 1(a) (Canadian Bankers' Association 1966) and is required to maintain reserves at the Bank of Canada. *Quebec Savings Banks Act*, s. 63. See generally Porter Commission, 147-154 and Neufeld, 140-164.

10. *Trust Companies Act*, R.S.C. 1970, c. T-16.
Loan Companies Act, R.S.C. 1970, c. L-12.

    The extent of federal powers over the non-banks has never been conclusively decided. The leading case on banking *Tennant v. Union Bank*, [1894] A.C. 31, is authority for very broad federal powers over banking. However, it does not follow that such power as exercised in respect to chartered banks is also exercisable in respect to non-banks doing a similar business.

    It is probable that "banking" in the constitutional sense covers institutions conducting a chequable deposit business. See *Re Bergethaler Waisenamt*, [1949] 1 D.L.R. 769, [1949] 1 W.W.R. 323 (Man. C.A.); *Caisse Populaire Notre Dame Ltée v. Moyen*, (1967), 61 D.L.R. (2d) 118, 59 W.W.R. 129 (Sask. Q.B.); cf. Paget, 1-8. The federal government would therefore have the power to assume jurisdiction over the payments activities of the non-banks.

    See generally McDonald, *The BNA Act and the Near-Banks: A Case Study in Federalism*, (1972) 10 Alta. L. Rev. 155.

11. The Alberta Treasury Branch and the Province of Ontario Savings Office.

12. See Porter Commission, 92-93.

13. See *Bank of Montreal v. Bay Bus Terminal (North Bay) Ltd.*, [1964] 2 O.R. 425, 45 D.L.R. (2d) 705 (C.A.); new trial [1972] 1 O.R. 657, aff'd [1972] 3 O.R. 881, 882-885, 30 D.L.R. (3d) 24, 25-29.

14. See generally Neufeld, 81, 102-105, 439-440.

15. As instrumentalities of the Crown, such institutions are suable only on terms specially established by the legislature. Their asset structure is also often heavily weighted in favour of government obligations.

16. Deposits are not legal tender. See notes 1 and 2 *supra*. Although the benefit of deposit insurance may inure to the transferee, the claim is not as liquid as money. Nor is the other right of the transferee on failure—suit of the drawer—readily transferable.

    Absent risk of failure or a legal tender requirement, the transferable deposit is a perfectly acceptable means of payment.

17. Until quite recently, the bank-note was a promissory note in form, and was governed by the provisions of the *Bills of Exchange Act*. See Hearings, House of Commons Standing Committee on Finance, Trade and Economic Affairs (1st sess; 27th Parl.) 2012 (1966).

18. See Department of Communications/Department of Justice Task Force, Privacy and Computers (Information Canada, 1972).

19. See text at 59, *infra*.

20. Examples are taking a short-term obligation in payment with intent to immediately refinance for the purpose of avoiding the consumer bill sections of the *Bills of Exchange Act*, or use of a financing overdraft to avoid sales credit regulation where the overdraft was extended through a plan involving merchant display—"use your X-plan card here".

    Neither is presently illegal, although cooperation in the first was discontinued by at least one institution after an expression of concern by the regulatory authorities.

21. In the U.S., the National Science Foundation has commissioned a $200,000 multi-disciplinary "technology assessment" study of the social implication of payments developments. The grantee is Arthur D. Little Co. Payment Systems Newsletter, January 1974, p. 4, col. 1.

22. Report of the Atlanta Payments Project, Phase III vol. II, 311-315 (1972). Estimated costs to a person in the $10-12,000 income range were $.27-33/cheque.

23. The unacceptability may be based on the possibility of a stop-order, which would necessitate suit, on fears of potential defects in title, or on a simple preference for cash.

24. "Third-party credit card" includes both bank and travel and entertainment cards.

25. This assumes that the credit card is not functioning as a loss leader, and that the issuer is not covering such losses out of revenue derived from the extended payment feature of the cards. The discount must of course cover transaction costs, other risks and interest not otherwise allocated.

26. At present, the encoded information has no legal effect apart from contract. See *Burnett v. Westminster Bank Ltd.*, [1966] 1 Q.B. 742; [1965] 3 A11 E.R. 81.

27. In a case occurring in Atlanta, an employee's identification number was encoded by mistake, instead of his bank account number. The transaction passed all control routines. The resulting failure to deposit the employee's pay to the proper account caused an overdraft not only in his own account, but also in another personal account to which he made periodic payments. Two separate sets of consequential dishonours thus resulted from the employer's error.
(Speech by Allan Lipis, Director, Atlanta Payments Project to Canadian Symposium on Systems for the Transfer of Funds, Toronto, November 9, 1973).

28. The fictitious payee rule requires that instruments payable to non-existent or ficticious persons be treated as payable to bearer. *Bills of Exchange Act*, s. 21(5). Its most common effect is to shift the loss of certain frauds from the drawee bank to the business drawer. The rule is narrow, and covers only some ways of padding accounts payable. See Falconbridge, 482-487. Cf. UCC 3-405 which extends the rule to cover both imposture and all padding of accounts payable, but requires an apparently regular series of endorsements before it can be applied.

29. This rule is most familiar in its common sense form: start the amount of a cheque in words at the extreme left of the space provided and line out any unused space at the right. See Falconbridge 562-565. Cf. UCC 3-406. The consequence of negligent drawing is that the loss is initially shifted from drawee to drawer, i.e. from bank to customer.

30. See Galbraith, 94; UCC 4-406. See, for a commercial account agreement, *Arrow Transfer v. Royal Bank*, (1970) 9 D.L.R. (3d) 693, (B.C.S.C.), aff'd (1971) 19 D.L.R. (3d) 420 (B.C.), aff'd [1972] S.C.R. 845, 27 D.L.R. (3d) 8.

31. See *Tournier v. National Provincial Bank* [1924] 1 K.B. 461. The exceptions to the requirement of confidentiality are so phrased as to allow considerable leeway in the result. See, e.g., *Income Tax Act*, S.C. 1970-71-72, c. 63, s. 231(3) and *Canadian Bank of Commerce v. A.-G. Canada*, [1962] S.C.R. 729, 35 D.L.R. (2d) 49.

32. The dearth of reported cases would appear to indicate that persons desiring credit are readily induced to grant such consent in the broadest terms. Or it may indicate that as long as the banks do not maintain a central master file for their operations, the cost of consolidating such information exceeds its usefulness. See the agreed facts in the *Canadian Bank of Commerce* case, *supra* note 31. The latter argument is technologically obsolescent.

There has recently been a spate of provincial legislation on credit information. See

B.C.: *Personal Information Reporting Act*, S.B.C. 1973, (2d sess.) c. 108;

Manitoba: *Personal Investigations Act*, S.M. 1971, c. P3?;

Newfoundland: *Credit Reporting Agencies Act*, S.Nfld. 1973, Act 76;

Nova Scotia: *Consumer Reporting Act*, S.N.S. 1973, c. 4;

Ontario: *Consumer Reporting Act*, S.O. 1973, c. 97;

Saskatchewan: *Credit Reporting Agencies Act*, S.S. 1972, c. 23.

Generally, this legislation has not sought to regulate the terms of consent to release of information exacted from prospective borrowers. It protects only natural persons. It does not prevent abuse of confidential data within a single business entity with diverse operations. (Quare: how diverse should a deposit institution be allowed to be? can it take releases in favour of related corporations?) In some cases, the legislation is restricted to credit reporting for profit—but deposit institutions are also likely to exchange data cooperatively on a no-cost basis. *Cf.* proposed *Bank Act*, s. 138(2) (*d*), Bill C-227 (1st sess.; 29th Parl.), C-7 (2d sess.; 29th Parl.)

33. See D. Parker et al. *Computer Abuse* 38-41 (Stanford Research Institute—1973).

34. *Cheque truncation:* a proposed technique for transferring payments in which the payor continues to issue cheques. The data on the cheque is sent forward electronically by the depository, which retains the cheque. Variants are suggested in which the cheque is retained by other banks in the collection chain. Cheque truncation, from the legal point of view, is far more complex under the *Bills of Exchange Act* than the UCC. Compare *Bills of Exchange Act*, s. 85-93 with UCC 3-501 (c), 3-504 and Comment.

Non-return of cheques by the drawee: a proposed return to the early practice of banks. The cheque is transmitted to the bank, but never returned to its customer. Since regional or national data-processing will soon be used by Canadian banks, the technique might result in cheques drawn on regional offices rather than branches. The amount of paper-shuffling eliminated by this technique depends on the extent to which the bank adopting it verifies signatures. If most signatures are not verified, cheques can be filed as received. If signatures are verified, the cheques must be sorted and distributed to the extent required to make this possible. In either case, efficient retrieval procedures must exist.

35. "Float" or transit is the total of items moving in the system. Because the system does not execute transfers instantaneously, items in motion are held by the deposit institutions.

"Debit float", which is created in cheque collections, occurs when deposits are credited to A's account before they can be charged to B's. In the intervening period, the deposit institutions as a group have created a deposit—money—in A's favour. If that deposit is used to off-set an existing loan to A, or if A is allowed to draw against it, A is receiving an interest-free loan. Deposit institutions generally favour reducing debit float.

"Credit float" is less common. Examples today include the money with which traveller's cheques are purchased between purchase and use, and the funds collected by banks remitting fuel or utility bills between collection and presentment of the remittance by the payee. Credit float is similar to an interest-free deposit and is considered desirable by deposit institutions.

36. See *Arrow Transfer v. Royal Bank of Canada*, (1971) 19 D.L.R. (3d) 420 (B.C.), aff'd [1972] S.C.R. 845, 27 D.L.R. (3d) 81. The judgments of Justices Nemetz and Laskin indicate broad grounds for contesting the effect of such agreements by both commercial and non-commercial parties.

37. Since the 1964 report of the Porter Commission, there have been important changes in the *Bank Act*, the *Trust Companies Act* and the *Loan Companies Act*. In addition, the creation of the Canada Deposit Insurance Corporation has served to promote uniformity of structure among non-federally chartered institutions.

38. In practice, such requirements are waived. The manner in which interest is credited to some such deposits raises doubts as to the applicability of the *Trust Companies Act*, R.S.C. 1970 c. T-16, s. 67 in the case of federally chartered companies.

39. See, e.g. *Trust Companies Act*, R.S.C. 1970 c. T-16.

40. See Neufeld, 439-441.

41. *Rules and Regulations Respecting Clearing Houses*, Rule 12 (Canadian Banker's Association 1966).

42. See Galbraith, 322-324.

43. See generally Galbraith, 347-353, 357-358. The standardized schedules referred to by Galbraith at 349 were withdrawn by the banks in anticipation of the legislation now contained in C-7 (2nd Sess; 29th Parl. 1974), and originally part of the *Competition Act* proposals (C-256, 3rd Sess; 28th Parl. 1971).

44. Canada Gazette, Part I, vol. 108, p. 452 (February 9, 1974).

45. See *Bank Act*, s. 75 (2) (a). This bank has since 1970 been expanding the portion of shares held by Canadian residents with a view to freeing itself from these restrictions.

46. *Ibid.*

47. See Economic Council of Canada, Interim Report on Competition Policy 153-157 (1969); Porter Commission 124-128, 369-376 (1964).

48. Concentration is an economic concept. If a market is dominated by several large firms, the industry concerned is said to have a high degree of concentration. Movement from an economically perfect market of small competitors towards monopoly is movement towards increased concentration. High concentration is generally associated with relative immunity from market forces, decreased economic competition and cosmetic competition to protect the market from outsiders who might otherwise seek to enter.

49. If this is not possible, the payee is deprived of the use of his money until the transfer can be collected. With turnover ratios on current and PCA accounts in the 100-125 range, a payee who must wait for his money is substantially disadvantaged.

50. An example of the second situation is the bill-paying procedure where deposit institutions accept bill payments for a utility and remit the vouchers accompanied by a single draft in settlement.

51. See Galbraith, 331-333. Perhaps the closest approach is the clearing network of the caisse populaire group in the province of Quebec. The arrangements for interchange of bank credit card vouchers can also be considered as supplementary to the clearing network.

52. Publicly available material includes the description in Canadian Bankers Association, Bulletin (Jan. 1968); *Rules and Regulations Respecting Clearing Houses* (Canadian Bankers Association 1966) and Galbraith, 327-340, 346-359. Since Galbraith wrote, the terms and charges associated with non-bank service accounts have become competitive and are subject to negotiation between banks and non-banks. Certain banks have also expanded the number of points at which they will receive non-local items.

53. *Rules and Regulations Respecting Clearing Houses*, *supra*.

54. S.C. 1900, c. 93, s. 16(2)(*c*), 16(3).

55. Non-banks have complained of discriminatory treatment. The Porter Commission found these complaints established the opportunity for such treatment, but not its occurrence. Porter Commission 182. Similar complaints were encountered in the field work for this study. Their validity cannot be established without arriving at cost figures for the clearing system and an analysis of the effects of various settlement practices. It can however be said that the banks' opportunity for discrimination and control over interchanges of new payment transfers and planning for such changes are a competitive disadvantage to non-banks.

56. *Rules and Regulations Respecting Clearing Houses*, *supra* note 52, Rule 1. The exceptions are Quebec Savings Banks and the Bank of Canada, which is a member at agency cities, but has no vote.

57. Payment Systems Newsletter, Oct. 1973, p. 1, col. 1.

58. Bill C-227 (1st Sess.; 29th Parl.) (1973); C-7 (2nd Sess.; 29th Parl.) (1974).

59. Porter Commission 390-394.

60. Economic Council of Canada, Interim Report on Competition Policy 153-157 (1969).

61. Insulation from political pressures may be illusory, and will probably depend on the extent to which competition policy lays guidelines for the clearing structure. The alternative source of expertise is the Inspector-General of Banks, but he would be placed in an impossible position, since he would have detailed knowledge of bank operations derived from his other functions which he would not have with respect to the non-banks. In addition, the public role as regulator poses conflicts with the largely confidential role as inspector for solvency purposes.

62. *Bank of Canada Act*, R.S.C. 1970, c. B-2, s. 14. See also Porter Commission 539-545.

63. And with certain other instruments which are negotiable by custom. Most of these would be mistaken by a layman for a cheque.

64. A mere "transferee" of an instrument has lawful possession and nothing more. If he has given value, he can compel the endorsement of his transferor, and thus become a holder.

Thus, although the "transferee for value" lacks the procedural advantages of a holder, he can obtain them.

The third status, holder for value, produces the anomalous result that failure or absence of consideration as a defense must be treated separately from the so-called defects of title. The status was eliminated under the UCC without adverse result.

65. The most common devices are "cut-off" clauses, now barred in most consumer financing and "non-dispute" clauses, which are still used in consumer agreements.

66. See page 59 *infra*.

67. See pages 22-26 *infra*.

68. The forms commonly used are designed to confine paper transfers to banking channels after deposit—thus removing considerable incentive and opportunity for frauds and thefts.

69. See Eddy, *Impact of the Computer on the Canadian Payments System* 8-13 (unpublished staff study on file at Law Reform Commission of Canada) (1973).

70. *Bills of Exchange Act*, s. 139. If the bill is drawn to raise credit for ("accommodate") a party, payment in due course by that party discharges the bill.

71. Where the instrument is drawn payable at a particular place, the acceptor or maker is not entitled to discharge for non-presentment, but costs of suit are in the court's discretion. *Bills of Exchange Act*, s. 93, 183.

72. Presentment is the formal demand for payment (or acceptance) made by a holder. Failure to pay (or accept) on timely presentment is dishonour. Notice of dishonour is generally required to charge parties secondarily liable.

73. The drawer of a cheque is discharged to the extent that he is a creditor of the bank to a greater extent than he would have been had the cheque been paid, if he suffers actual damage. *Bills of Exchange Act*, s. 166; see Falconbridge 865-868. The holder may claim for the amount in the liquidation of the bank.

As to the drawer of a bill of exchange compare Chalmers, 135, 140 with Falconbridge 798-800.

The issue is not academic in Canada, since a sizeable number of instruments used by consumers as "cheques" are in law bills of exchange, but not cheques.

74. See generally University of Manitoba Legal Research Institute, *The Status of Certified Cheques* in Law Reform Reconnaissance Program (1973).

75. Originally, the common law gave a discharge whenever damage to the drawer could be shown. But such damage was not easy to show absent bank failure. *Laws v. Rand*, (1857) 3 C.B.N.S. 442, 140 E.R. 812 (cheque drawn by partner in firm name under questionable circumstances—insufficient signatures for bank to honour—enforced against other partner although held until after firm dissolved). The case of bank failure was covered specially by the statute. *Bills of Exchange Act*, s. 166(1). See on the other issues, *Hopkins v. Ware* (1869) L.R. 4 Ex. 268, *Heywood v. Pickering*, (1874) L.R. 9 Q.B. 428.

In Canada, see *Dumny v. Yakimischak*, (1954) 12 W.W.R. (N.S.) 635 (Q.B. Man.); Falconbridge 866 but see Chalmers 135, 251-253, 341-342. Cf. UCC 3-802, 3-601, 3-502(1)b. The UCC is an improvement on the question of the effect of discharge of the instrument. But the issue of laches remains explicitly open. See UCC 3-601(2).

76. Negotiation between deposit institutions is a concept which has lost its utility. It is essential to operate the system that transfer orders be mass-processed. Rights in negotiations turn on the form of individual transfers. Prior to enactment of s. 165(3) of the *Bills of Exchange Act* the system was in conceptual chaos. As shown later, s. 165(3) produced a semblance of order at the expense of other, and perhaps more important, values.

77. To obtain payment, a thief would be required to forge the payee's endorsement. The typical commercial payee endorses restrictively for deposit by means of a rubber stamp. Once so endorsed, such paper is useless to a casual thief.

78. In addition to the account, the payee has the alternative of the action on the instrument.

79. See *Price v. Neal*, (1762) 3 Burr. 1355.

80. See B. Howard, *Is the Bill of Exchange Outmoded?* 66 Canadian Banker 71-78 (1959).

81. *Price v. Neal*, (1762) 3 Burr. 1355; cf. *Arrow Transfer v. Royal Bank*, [1972] S.C.R. 845, 27 D.L.R. (3d) 81.

82. See *Arrow Transfer v. Royal Bank*, *supra*.

83. See Paget, 330-331; cf. *Jervis B. Webb Co. v. Bank of Nova Scotia*, (1965) 49 D.L.R. (2d) 693.

84. *Slingsby Bank v. District Bank* [1932] 1 K.B. 544.

85. *Bills of Exchange Act*, s. 49(3).

86. *Id*, s. 49(4).

87. De la Durantaye, Traité des Effets Négociables, 68-69 (1964).

88. Paget, 341.

89. *Charles v. Blackwell* (1876) 1 C.P.D. 548, 555 (per Lindley, J.) aff, d (1877) 2 C.P.D. 151, 162-163.

90. *Young v. Grote*, (1827) 4 Bing. 253, 130 E.R. 764; *London Joint Stock Bank v. McMillan*, [1918] A.C. 777 (H.L.); *Will v. Bank of Montreal* [1931] 3 D.L.R. 526, [1931] 2 W.W.R. 364 (Alta.).

91. Consider the case of a materially altered instrument the entry for which is conclusive under the account agreement between paying bank and customer, cf. *Huron and Erie Mortgage Corp. v. Rumig*, [1970] 2 O.R. 204 (C.A.)

92. "Neither forgery nor fraud are expressed as risks of the customer. The key words are 'verify the correctness' of statements of account received from the bank; 'notify the bank in writing . . . of any alleged omissions from or debits wrongly made to or inaccurate entries in the account'. It is in respect of these, unless there is timely notice, that 'the account as kept by the bank shall be conclusive evidence' that it is correct, and that, subject to what is excepted (this includes 'payments made on forged or unauthorized endorsements'), the bank is to be free 'from all claims in respect of the account'.

    I find it strange that a bank which seeks by contract to throw the risk of all forged drawer signatures upon its customer should be so reticent about referring expressly to such an eventuality. It is not as if its verification form lacks subject-matter without it."

    Arrow Transfer v. Royal Bank, supra at 868, 27 D.L.R. (3d) at 97-98 (per Laskin J.).

93. See I. Baxter, Banking 59 (1968)

94. Approximately one-fifth of the payments made by negotiable orders are government drafts. Various social payments, such as family allowances and pensions are a large part of this group.

    Social payments are unique in that their recipients are often less able than the average citizen, through age, lack of education, or other physical or social disability, to cope with social change, institutional evasiveness, or a personal budget. But cost pressure on government makes the use of electronically transmitted direct deposits a virtual certainty in this area.

95. See Falconbridge, 193-196; Paget, 405, 432.

96. *Bills of Exchange Act*, s. 61 (1).

97. *Id.*, s. 54(2). But see *Bank of British North America v. Warren*, (1909) 19 O.L.R. 257

98. The commercial roles in which the lien becomes vital have not been common non-bank activities. As non-banks enter areas traditionally occupied by the banks, their case for such a lien becomes conclusive.

99. *Bills of Exchange Act*, s. 2(*h*), 60(1), 68, 69. See Falconbridge, 651-653 and the critique based on banking practice in Britton, Bills and Notes 153-158 (2d ed. 1961). The UCC adopts a contrary rule. UCC 3-206.

100. *Bills of Exchange Act*, s. 68(3); *Imperial Bank of Canada v. Hayes and Early Ltd.*, (1962) 35 D.L.R. (2d) 136, 38 W.W.R. 169 (Alta. S.C.).

101. *Imperial Bank V. Hayes and Early Ltd., supra.*

102. The case authority relied upon in the *Imperial Bank* case, and the previous Canadian cases, concerned themselves with items not customarily credited as cash unless discounted by the bank, in which case a restrictive endorsement would never be accepted. See Britton, *supra* note 99 at 157; Falconbridge, 653.

103. *R. E. Jones Ltd. v. Waring & Gillow, Ltd.*, [1926] A.C. 670 (H.L.) See Falconbridge, 625. The opposing, and it is submitted sounder, view finds support in Falconbridge, 625, Baxter, 56 and UCC 3-302(2). Although the Supreme Court of Canada appeared to follow *Jones v. Waring, supra*, in *Gallagher v. Murphy*, [1929] S.C.R. 288, [1929] 2 D.L.R. 124, various lower courts have considered the issue an open one. *Dominion Bank v. Fassal & Baglier Construction Co.* [1955] 4 D.L.R. 161 (Ont. C.A.); *Beneficial Finance Co. v. Kulig*, [1970] 3 O.R. 370 (Co. Ct.).

104. *Bills of Exchange Act*, s. 165(3).

105. S. Scott, *The Bank is Always Right: Section 165(3) of the Bills of Exchange Act and Its Curious Parliamentary History*, (1973) 19 McGill L.J. 78.

106. It might also have allowed a collecting bank to supply an "account payee" endorsement where it undertook collection of third-party deposits in the ordinary course of business—a problem neatly (but drastically) cured by s. 165(3).

107. The only alternative available to such losses is to freeze all deposited funds until collected—which is cumbersome and unacceptable to most depositors. The development of on-line clearing techniques will hopefully eliminate all or most of these losses.

108. *Bills of Exchange Act*, s. 165(3). (Emphasis added).

109. Whatever the Act may provide, the bank's status vis-à-vis its customer is agent for collection and lien-holder—not purchaser. It is obligated to account for any surplus. Cf. *Bank of British North America v. Warren*, (1909) 19 O.L.R. 257.

110. See S. Scott, *supra* note 105.

111. *Charles v. Blackwell*, supra note 89; as to the Civil Code, what fault exists in paying a holder in due course?

112. This applies to the normal collection of cheques. If an institution purchases commercial paper, obviously different considerations apply.

113. See text at 38-41, *supra*.

114. The shelter doctrine establishes that any person who takes an instrument after a holder in due course, and is not involved in fraud or illegality prior to that holder's possession, is entitled to prove that holder's status, and having done so, to assert his rights. See *Bills of Exchange Act*, s. 57; Falconbridge, 633.

115. Where a charge to the depositor's account is feasible, deposit institutions do not always use it in preference to suit. See *Huron and Erie Mortgage Corp. v. Rumig*, [1970] 2 O.R. 204 (C.A.) and the dissent per Laskin, J.A.

Such behaviour is probably related to other, unmatured claims of the institution against the depositor.

There may still be factors leading to an occasional suit against the drawer in preference to the payee—such as superior financial standing of the drawer. The desirability of direct recovery from the wrong-doer must be balanced against the institution's right of action on the instrument.

The change suggested, if coupled with the suggestion by Laskin, J. in *Rumig*, would encourage initial action against the depositor in the usual case.

116. This requirement might be relaxed to accommodate common business situations in which institutions supply endorsements. See note 105, *supra*.

117. See *Salter & Arnold Ltd. v. Dominion Bank*, [1926] S.C.R. 621; [1926] 3 D.L.R. 684; *Re Sutcliffe & Sons Ltd.*, [1933] O.R. 120 (C.A.).

118. Bankruptcy: *Bankruptcy Act*, R.S.C. 1970 c. B-3, s. 47(c), (*d*).

Garnishment: See e.g. R.S.O. 1970 c. 152, s. 14 (2). Notice of Death: *Bills of Exchange Act*, s. 167 (b).

119. *Bankruptcy Act*, s. 75, 77.

120. See UCC 4-405.

121. *Caron v. Caisse Populaire de Granby*, (28 nov. 1973) (Que. C.A. M12,487).

122. *Bills of Exchange Act*, s. 166, 86. See Falconbridge, 866.

123. See Falconbridge, 856.

124. See, e.g. *Cowie v. Richards and O'Brien*, (1960) 50 M.P.R. 107 (N.B.C.A.).

125. See, e.g. *Criminal Code*, s. 320 (5), *Bills of Exchange Act*, s. 189 (d).

126. See, e.g. *R. v. Hall*, (1960) 31 W.W.R. 110, 127 C.C.C. 433.

127. See the discussion of s. 165 (3), *Bills of Exchange Act*, *supra*.

128. See pages 17-19, *supra*.

129. See pages 22-28, *supra*.

130. See pages 21-22, *supra*. The basic framework for loss allocation derived from unauthorized issue and negotiation should be based on insurance principles. See Baxter, Banking 59 (1968). The goal should be collection (or transmission) for the account of the payee—subject perhaps to a single transfer for those who customarily "bank" with their corner grocer or other local merchants. Such a transferee of a *paper* instrument could be entitled to the right of a traditional holder in due course on a showing that he would so qualify, that the payee is not a merchant, and that his role as "banker" is not his principal line of business.

131. The primary differences would be that chargeback rights would not be created, as in the consumer transaction, that the transfer would be treated as cash payment for purposes of finality, and that allocation of risks of unauthorized issue would be against the issuer in cases of imposture and on all electronically initiated transfers.

The goal would again be collection (or transmission) for the account of the payee—subject to a possible single transfer exception for non-commercial payees on a paper transfer.

132. The North American rule is that there is no title after a forged endorsement, resulting in conversion liability to the holder for all who transfer the instrument after the forgery and no right in the paying bank to charge the drawer's account. It also allows the paying bank to recover from the collecting bank, and each party so sued to recover against prior transferors, until the wrong-doer is (theoretically) reached.

The English rule disallows any recovery by a payor against holders in due course or those whose position has changed in reliance on the payment. *Cocks v. Masterman*, (1829) 9 B. & C. 902, 109 E.R. 335 (K.B.); *London & River Plate Bank v. Bank of Liverpool*, [1896] 1 Q.B. 7. But see *Imperial Bank v. Bank of Hamilton* [1903] A.C. 49, 58 (P.C.) It also grants immunity from actions by the holder since payment by the drawee banker is deemed payment in due course if made in good faith in the ordinary course of business. *Bills of Exchange Act (U.K.)*, (1882) 45 & 46 Vict., c. 61, s. 60. See Chalmers, 209-211. The collecting banker must apparently derive his protection from s. 2, 4 *Cheques Act* (1957) (5 & 6 Eliz. 2, c. 36).

The suggestions here made for a commercial transfer technique have been more broadly elaborated in several Civil Code jurisdictions. See Baxter, On the Development of Commercial Law, (1964) 24 Rev. du Bar. 241, 255-261, 262-265.

133. The reason for this suggestion is to allow computerization of the financial files of all significant grantors of consumer credit—looking towards the consequential development of real-time availability of total financial credit data on individual consumers. The implications in terms of consumer bankruptcy prevention and a reform of the law of creditor's remedies would be substantial, since use of

such "instruments" could make a debt registry feasible. These developments await the growth of a national information handling network and computer service availability to the small credit grantor.

134. So long as the instruments concerned are paper-based the necessary changes amount to no more than a conceptual rearrangement of the Act. Such sections as 14-16, 21, 68, 168-175 and 188-190 mark instances in which the present Act substantially restrains or eliminates one or more of the recognized characteristics of negotiability in favour of competing policies such as consumer protection, freedom of contract or creation of specialized transfers restricted to the clearing system.

135. The issue is whether the identity of the information transmitted to the traditional bill or note can transcend the lack of such traditional formal characteristics as a writing (or set of writings) reifying the transaction and the use of a signature for identification.

136. Federal legislation which clearly conflicted with valid provincial policy with respect to property and civil rights was sustained quite soon after Confederation as (1) a direct exercise of the banking power, *Tennant v. Union Bank of Canada*, [1894] A.C. 31 (P.C.); and (2) a direct exercise of the bankruptcy power, *Cushing v. Dupuy* (1880) 5 A.C. 409 (P.C). Such interference with e.g. executions was also stated to be (3) an ancillary exercise of the bankruptcy power, *Voluntary Assignments Case* (*A.-G. Ontario v. A.-G. Canada*), [1894] A.C. 189 (P.C.) (dictum). See Laskin, "Peace, Order and Good Government" Re-examined, (1947) 25 Can. Bar Rev. 1054 for a critique of the ancillary jurisdiction doctrine.

137. Even under the most restrictive formulations of federal power endorsed by the courts, the economic importance of a uniform national payment system considered against the totality of enumerated federal powers would appear to justify federal jurisdiction. See *Reference Re the Alberta Statutes*, [1938] S.C.R. 100, [1938] 2 D.L.R. 81.

138. A demand draft accepted payable at a bank is sufficient authority for the banker to pay. *Kymer v. Laurie*, (1849) 18 L.J.Q.B. 218. Accord: *Hubert v. Home Bank*, (1910) 20 O.L.R. 651, 654. Demand drafts drawn payable at a bank must be presented to the drawee for acceptance. *Bills of Exchange Act*, s. 75(2). But these transfers are never accepted. If the drawer acts as the customer's agent, the bank has no knowledge of such authority. If the drawer acts in his own right, the bank has nothing from which to infer its customer's acceptance.

Canada and England have never developed a doctrine of "virtual" or "collateral" acceptance. The U.S., which had allowed an acceptance to be expressed in a writing separate from the instrument, wisely abandoned these doctrines in the UCC. See UCC 3-410 and Comment; cf. Uniform Negotiable Instruments Law, s. 135-135.

139. See Payment Systems Newsletter Dec. 1973 p. 4, col. 1 (National BankAmericard, Inc.—U.S.—Base II system).

140. So long as the instrument is in the form of a bill of exchange, and the law is unchanged, the instrument must be presented to the drawee for payment.

141. One such service to consumers has already been introduced and withdrawn in the U.S.A. by the Seattle First National Bank. The reasons for its withdrawal were a limited potential market (not enough push/tone phones in the market area) and poor consumer response. Most observers believe the service was technically sound, but prematurely marketed.

142. The role of chartered banks and other deposit institutions in providing such services, as opposed to computer service bureaux, and the settlement of technical specifications for the retailer terminal in the event that it is used to access more than one computer system, are key regulatory issues in the growth of such system.

143. See Baxter, *On the Development of Commercial Law*, (1964) 24 Rev. du Bar. 241-242. The stultifying effect of both the *Sale of Goods Act* and of *Article 2—Sales* of the Uniform Commercial Code on the seller's duties is well-known. Even though these Acts, and the *Bills of Exchange Act*, are referred to as "Codes" by the courts, they have never induced the freedom from precedent associated with the great civil law codes. Instead, uncritical application of the doctrine of parliamentary sovereignty has often deprived the common law of its inherent capacity for development and reform through restatement of its rules.

144. See, e.g., Paget, 99-110, 118-120.

145. See *Bank of Montreal v. The King*, (1906) 38 S.C.R. 258 and Paget, 105-108.

146. See *Arrow Transfer v. Royal Bank*, [1972] S.C.R. 845, 27 D.L.R. (3d) 81.

147. Some provinces require such a limit by statute. See Manitoba *Consumer Protection Act*, C.C.S.M. c. C200, s.116

148. See, e.g., advertisement of the Chargex banks in Toronto Globe and Mail, 13 March 1974, P. 11, col. 2, "To date, no innocent (sic) cardholder has had to pay this liability charge."

149. The term PIV—personal identity verification—is sometimes used to describe techniques in which the computer would recognize an account holder by finger-print, voice print, hand geometry or signature analysis. These techniques are not presently economically feasible.

150. Again, as a matter of policy, but not of law, this would appear to be the institutional position. Contrast the language of the verification agreement in *Arrow Transfer v. Royal Bank*, [1972] S.C.R. 845, 849, 27 D.L.R. (3d) 81, 83 with the bank's position in *Stewart v. Royal Bank and Fraser*, [1930] 2 D.L.R. 617, 620 rev'd [1930] S.C.R. 544, [1930] 4 D.L.R. 694.

151. Cf. UCC 4-406 (3) and Comment 4 thereto.

152. Cf. *Arrow Transfer v. Royal Bank*, [1972] S.C.R. 845, 855-878, 27 D.L.R. (3d) 81, 89-103 (Laskin, J. concurring).

153. It should be recognized that this abuse could be substantially curbed by a simple verification of passenger identification.

154. See note 148, *supra*.

155. The sales voucher or "sales draft" is the paper slip signed by the cardholder when making a purchase. It is non-negotiable.

156. See note 139, *supra*.

157. Under such a system the payor bank honours all transactions received as pre-authorized, without any clearance against an authorization file. It is still possible to "stop order" a specific pre-authorized debit at the payor bank by using the same procedure as is used on a cheque. However, this procedure rejects tentatively *all* transactions for the amount in question and may generate a substantial burden of manual transactions. Unexpected entries—such as those to the wrong account—would be caught only by examination of the statement by the customer (or by the bank in handling a potential overdraft).

In a double authorization system entries can be verified as to drawer, sender (of credits), and, in some cases, amount, by the payor bank. The consumer through this verification process retains greater control over the entries processed into his account.

158. The problem is that the debtor—e.g. an employer paying wages—may succeed in holding funds which should have been paid away in accounts which are liable to be set-off against his debts to the deposit institution.

Adequate schedules for requiring the debtor to settle for his transfers, and control of the deposit institution power to recall credit transfers can solve the problem. An essentially similar problem occurs when a deposit institution combines accounts through its set-off in a debit transfer system.

159. The threat of computer error can be greatly decreased if the error is immediately reversible on the objection of the customer. See SCOPE Procedure Guide, Rule 8 and pp. 37-38 (1972). SCOPE is now incorporated as the California Automated Clearing House Association (CACHA); its operating agent is the Federal Reserve Bank of San Francisco.

160. See Baxter and Johnston, *New Mechanics for Securities Transactions*, (1971) 21 U. of T.L.J. 336 and Baxter and Johnston, *Transfer of Investment Securities—Some Current Proposals*, (1972) 10 Osgoode Hall L.J. 191.

161. Considerable work towards a uniform law for international payments instruments has been done under the auspices of UNCITRAL, the United Nations Commission on International Trade Law. See UNCITRAL Draft Uniform Law on International Bills of Exchange, A/CN. 9/67 (1972). This work can be expected to expand towards electronic transfers. See UNCITRAL, 5th Report Un. Doc. A/8717 (1972) p. 31.

162. See generally D. Parker, Computer Abuse 91-112 (Stanford Research Institute 1973).

163. See Kirby, The Names the Thing: Financial Communication Device, Not Automated Teller Machine, (1974) 91 Banking L.J. 135; Payment Systems Newsletter, May 1974, p.1, col. 1 (State of Washington adopts legislation forcing commercial banks to share remote teller facilities as condition of regulatory approval).

164. See Payment Systems Newsletter, Dec. 1973, p. 3, col. 1.

165. Failure of the In-Touch system to achieve viable levels of sales is laid to consumer fears of the computer and an insufficient number of push-tone phones (20%) in the market area. See Payment Systems Newsletter, June 1973, p. 8; Payment Systems Newsletter, Jan. 1974, p. 8.

166. The proposed legislation is somewhat broader than the sections of the *Combines Investigation Act* from which it is derived. In addition, the nature of banking makes certain activities much more central to a banker's business than they would be, for example, to a manufacturer. See s. 28-29, C-277 (1st Sess.; 29th Parl. 1973), C-7 (2nd Sess.; 29th Parl. 1974).

167. See Report of the Canadian Computer/Communications Task Force, *Branching out* II, 14-16, 38-49.

168. "Some for the glories of this World; and some Sigh for the Prophet's Paradise to come; Ah, take the Cash, and let the Credit go, . . ." Omar Khayyam, Rubiyat, Stanza XIII quoted R. Steffin, Commercial and Investment Paper 463 (3d ed. 1964), commenting on *W. A. White Brokerage Co. v. Cooperman*, 207 Minn. 239, 290 N.W. 790 (1940).

169. For example, it has been suggested that the funds debited in real-time from consumer accounts should be batched and held overnight before forwarding to the merchant's bank for credit. Statement of Thomas Whaley, Southeast Bankcard Association, Atlanta Payments Symposium 27 Feb. 1973. Obviously, clear justifications must be offered for such a procedure.

170. A bank could adopt remote entry of "on-us" items, for which it is banker to both deposit and drawer.

An on-us cheque drawn on a Halifax branch and deposited in Vernon, B.C. is today charged by one bank to the drawer's Halifax account on the day of deposit. The reports showing the charge reach the Halifax branch the next morning. The cheque is delivered to the branch the following day. Statement of C.N. Downing, Deputy General Manager, Royal Bank of Canada, Meetings of the Data Processing Institute/Canadian Information Processing Society Ottawa, 11 June 1974.

No presentment can occur until the cheque itself reaches Halifax. *Bills of Exchange Act*, s. 85(3). Cf. *Capital Associates Ltd. v. Royal Bank of Canada*, (1970) 15 D.L.R. (3d) 234, aff'd (1973) 36 D.L.R. (3d) 579.

The bank is doing its business in a manner which the Act does not provide for; it accordingly becomes the bearer of numerous risks.

Some notion of the risks involved may be gained by asking whether the account debit could be defended by the bank (1) when made and (2) after the cheque reaches Halifax, against (a) the drawer and (b) a third party claimant of the account. Also in issue are when the cheque is finally paid for purposes of the rule of *Price v. Neal*, and whether, if the bank cannot enforce the charge against the drawer, it has lost its chargeback rights against its depositor either legally or as a practical matter.

Other banks willing to indemnify the drawee against all the above risks, including forgery and possible consequential overdrafts, might be able to make arrangements for interchange of messages and cheques if their system could satisfy technical and security criteria of the drawee bank.

171. See, e.g., *Sale of Goods Act*, R.S.O. 1970 c. 421, s. 37(1)b.

172. The transaction is not legally equivalent to cash payment in the full sense because: (1) deposits are not legal tender; (2) the institution which has the payor's funds is not subject to suit by the payee, nor is even the payee's own deposit institution necessarily subject to suit until it has acknowledged receipt on the payee's behalf; (3) for some purposes, it may be desirable to allow the payee to renounce the benefit of such a payment. The problem is unlikely to arise in point-of-sale transactions, but it may be a serious one in other areas; and (4) any of the deposit institutions involved may fail while accountable for the payment and before the payee has received it irrevocably to his account.

173. For example, the risk of "no-account" cheques disappears. The risk of NSF cheques or over-limits on credit disappears. The risk of honouring a stolen card is substantially reduced, while the risk of honouring a revoked card disappears.

174. Murray, *Price v. Neal in the Electronic Age: An Empirical Survey*, (1970) 87 Banking L. J. 686.

See Also Murray, *A Legal-Empirical Study of the Unauthorized Use of Credit Cards*, (1967) 21 U. of Miami L. Rev. 811.

175. Replacement of forgery for payment purposes is suggested because private business decisions are involved. If forgery continued to be a possible charge, particular interest groups might be able to demand record-keeping procedures which would effectively prevent the introduction of efficient systems.

176. If the risk of institutional insolvency is ignored, the use of drafts in settlement or net daily settlement of transfers is roughly equivalent to true credit transfer apart from float effects.

177. Principally, the rights to charge back and to collect the instrument by suit.

178. For example, it appears that consumers are unaware that default in payment of a bank credit card account allows the bank a speedy, if drastic, remedy.

From the *Ottawa Citizen*, 21 June 1974, p. 41, col. 1: "Action Line" "[A bank credit card] not customer's bookkeeper. I relied on [a bank credit card] to handle my finances and as a result I'm flat broke. [The bank credit card] issued me a credit card (sic) with a $300 limit. I thought they wuld (sic) cut me off at the $300 mark. I heard nothing from them so I kept on spending. All of a sudden [the bank credit card] told me I owed $600. They wanted me to start making higher monthly payments. I couldn't afford them. I had a little money in my personal bank account but I needed it to pay other bills. Despite this the bank emptied my account and gave the money to [the bank credit card]. It was done without my permission, adding insult to injury. Was it legal? — Name Withheld. The procedure is legal under the Federal Bank Act. It is used against credit card holders only as a last resort. As long as card holders keep up their payments, [the bank credit card] isn't rigid about holding them to their borrowing limits. So you can't count on [the bank credit card] to do your bookkeeping and warn you if you are getting in over your head."

179. Disclosure is often praised as more in keeping with free market economics. For a legal-economic critique of disclosure as a solution, see Schwartz, *Optimality and the Cutoff of Defenses against Financier's of Consumer Sales*, (1974) 15 Boston College Industrial and Commercial L. Rev. 499.

180. *Bills of Exchange Act (Amendment)* R.S.C. 1970 (1st Supp.) c. 4, s. 190-192.

181. *Id.*, s. 189.

182. In Ontario, see s. 42, 42a, *Consumer Protection Act*, R.S.O. 1970 c. 82. Although lender and credit are broadly defined by the Act, these sections do not reach lenders who do not take by assignment. The normal lender is not a party in the consumer sale, and is affected by defenses arising from it only if this lack of privity is surmounted by case law or statute, such as *Bills of Exchange Act (Amendment)*, s. 189(2), (3).

In B.C., see *Consumer Protection Act* s. 15, S.B.C. 1967 c. 14 as amended S.B.C. 1971 c. 11. Although B.C. applies an extremely rigorous test to reach connected lenders under its unconscionable transactions relief provisions, the test is aimed at successors to the original lender. See *id.*, s. 20. The basic provision, like that of Ontario, does not catch direct consumer loans *per se*. Quare whether a direct loan to effectuate consumption is "otherwise inequitable" merely due to a cut-off effect—probably not. See *id.*, s. 17. Quare also if "fairly due in respect of the principal and cost of borrowing" allows recognition of a set-off against the principal when the lender is not the seller.

Manitoba has taken a broader approach. The *Consumer Protection Act*, C.C.S.M. c. C200, s. 67 broadens the normal approach to assignments. Additionally s. 69 reaches secured loans arranged by the seller as well as assignments.

Apart from the varied statutory material, a line of authority terminating in *Beneficial Finance Co. v. Kulig*, [1970] 3 O.R. 370 (Co. Ct.) is relevant in considering whether the financier, because of his

continued business association with the seller, should be considered as in privity with the buyer for the purpose of defenses arising from the sale.

183. Such a requirement in provincial legislation is constitutionally suspect, and avoided when possible. The negotiable instruments were covered by the federal legislation discussed above.

184. See text *infra* at 59. For discussion of the comparable problem in the U.S., see B. Clark and A. Squillante, *Law of Bank Deposits and Credit Cards* 207-208 (1970).

A critique of the cut-off effect as a feature of the market decreasing economic efficiency of consumer decisions is found in Schwartz, *Optimality and the Cutoff of Defenses against Financiers of Consumer Sales*, (1974) 15 Boston College Industrial & Commercial L. Rev. 499.

185. See text *infra* under the heading Finality of Payment at 54.

186. See e.g., Paget 288; UCC 4-107, 4-213(5).

187. *Price v. Neal*, (1762) 3 Burr. 1355, cf. *Imperial Bank of Canada v. Bank of Hamilton*, [1903] A.C. 49 (P.C.); *Bank of Montreal v. The King*, (1907) 38 S.C.R. 258.

The English and Canadian rule as to forged endorsements differs. Compare *Bills of Exchange Act (Can.)* s. 49(3), (4), 50 with *London and River Plate Bank v. Bank of Liverpool*, [1896] 1 Q.B. 7.

188. Proposed 12 C.F.R. 210-75 (U.S. Federal Reserve Board press release 19 Nov. 1973).

189. SCOPE Procedural Guide, Rule VIII, p. 45-46; Statement of Robert Robinson, Vice-President, Fulton National Bank, Atlanta to symposium sponsored by Atlanta Payments Project, 27 Feb. 1973.

190. A lien is a right to retain the possession of personal property as security for payment.

At common law, the seller's lien for the unpaid price and the chattel lien for services are both possessory. The statutory modification of the former, outside Quebec, by the local Sale of Goods Act, is essentially uniform. In Quebec, the unpaid seller may revendicate under Civil Code 1998-1999 even though out of possession.

But the modification of chattel lien rights has not been uniform. Most provinces have created a power of sale for the possessory lien, but only some have provided for limited rights to surrender possession without loss of the lien. These are usually restricted to motor vehicles.

See Alberta: *Garagemen's Lien Act*, R.S.A. 1970 c. 155 as amended. *Possessory Liens Act*, R.S.A. 1970 c. 279.

B.C.: *Mechanic's Lien Act*, R.S.B.C. 1960 c. 238 as amended.

Manitoba: *Garage Keeper's Act*, R.S.M. 1970 c. G-10 as amended.

N.B.: *Liens on Goods and Chattels Act*, R.S.N.B. 1952 c. 131 as amended.

Nfld.: *Mechanic's Lien Act*, R.S.Nfld. 1970 c. 229 as amended.

N.S.: *Mechanic's Lien Act*, S.N.S. 1967 c. 178.

Ontario: *Mechanic's Lien Act*, R.S.O. 1970 c. 267.

Sask.: *Mechanic's Lien Act*, S.S. 1973, c. 62 as amended.

Under the Civil Code, it appears there would be no problem in integrating the proposed chargeback. See C.C. 441; *Wilson v. Doyon*, (1964) C.S. 93.

191. Ontario Law Reform Commission, *Report on Consumer Warranties and Guarantees in the Sale of Goods* 110-123 (1972).

192. As a practical matter, deposit institutions elect to use these features of the payment system only in unusual situations. However, the election is in their uncontrolled discretion.

193. Compare Ontario *Consumer Protection Act* R.S.O. 1970, c. 82, s. 42a with Manitoba *Consumer Protection Act*, C.C.S.M. c. C200, ss. 67-69.

194. *Bills of Exchange Amendment Act*, R.S.C. 1970, 1st Supp. c. 4 (1969-70, c. 48); *Consumer Protection Act* R.S.O. 1970 c. 82, s. 42a (invalidating the cut-off effect in assignments; similar legislation is in force in other provinces); *Federal Discount Corp. v. St. Pierre* (1962), 32 D.L.R. (2d) 86 (Ont. C.A.); *Beneficial Finance Co. v. Kulig* [1970] 3 O.R. 370.

195. See, e.g., Ontario *Consumer Protection Act*, R.S.O. 1970 c. 82, s. 44a (S.O. 1971 vol. 2, c. 24); B.C. *Sale of Goods Act*, R.S.B.C. 1960 c. 344, s. 21A as amended S.B.C. 1971 c. 53, s. 1, S.B.C. 1973 c. 84, s. 15.

196. Ontario Law Reform Commission, *Report on Consumer Warranties and Guarantees in the Sale of Goods* (1972).

197. See U.S. Senate Committee on Banking, Housing and Urban Affairs, *Hearings on Inaccurate and Unfair Billing Practices* (s. 1630 and 914) (93rd Cong; 1st Sess.) 137-158 (1973) (testimony of

[illegible]